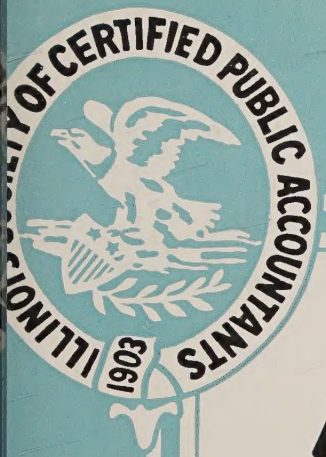

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PRESIDENT'S PAGE

Children are not the only ones who engage in daydreaming. Many of us sometimes permit our imagination to consider what the results might be if we were allowed a free hand in making wholesale changes in organizations with which we are familiar. This may be true with respect to our Illinois Society.

The organization of the Society, as in the case of any institution which has been operating for a number of years, is not the result of any one individual's plan. Programs have been initiated and revisions have been made from time to time by a large number of capable men who have actively served in various capacities. It might be appropriate to ask, would many substantial changes be recommended if each member independently prepared a complete blueprint without consideration for the past?

I am confident that pursuing this thought would generally confirm the belief that we do have a sound program and solid organization, and that a good job is being done. Such recommendations as may be advanced as a result of any member's informal "survey" should, of course, be passed along to the officers because it is not intended to imply that our Society is perfect.

A tabulation of the conclusions reached would probably disclose the most common were (1) that more could be accomplished if additional funds were available, and (2) that the logical source of the needed funds is through increased dues revenue.

The primary purposes for which the Society was formed include the promotion and maintenance of high standards of integrity and competence within the accounting profession, safeguarding the interests of the general public and CPAs in the practice of accountancy, and encouraging young people to enter the profession. These purposes and the others specifically enumerated among the corporate objectives clearly justify the organization, and it is gratifying that so much is being accomplished in all areas.

The accomplishments are attributable, in large part, to the fact that our 3,200 members represent the major portion of the CPAs in the State and our members unselfishly devote a substantial amount of time in service to the profession by working on the various committees. The members represented on the committees include almost 12% of the total membership (a very high percentage, for which we are thankful and justifiably proud), and the value of the work done can not be reduced to dollars and cents.

Active committees invariably recommend worthwhile programs, but the Board must carefully allocate the available resources. Professional accountants, of all people, are aware that no individual person or business, governmental or social organization can continue for long to spend in excess of his or its income. The Illinois Society did use part of its accumulated working capital during the 1958-59 fiscal year and it is expected there will be a further depletion of prior years' savings at the end of the current year. Consequently, an increase in dues revenue is essential, and it can be achieved only through a larger number of participating members and an increase in rates.

Each member has an obligation to utilize every opportunity to encourage other eligible CPAs to join the Society. The number of such prospects is substantial but nonetheless limited. The problem presented by rising costs cannot be solved in this way alone even though our Membership Committees continue to be active and effective.

The Board of Directors of the Society considers every proposed activity in the light of the relationship between the cost and the benefits which can be reasonably expected. It is regrettable that in some cases activities must be restricted merely for lack of the necessary funds.

When the daydreaming is concluded and the mental picture of the "ideal" Illinois Society of Certified Public Accountants is completed, the fairness of the dues schedule recently recommended to the members by the Board of Directors should be obvious to all. The Directors are keenly aware of their responsibilities, and it is earnestly hoped that the members will respond by their wholehearted support for the dues structure which reflects careful study and thoughtful attention to the need for equitable sharing of the expense of carrying on the program of the Society.

ACCOUNTING – CHANGING PATTERNS: The Impact of Regulatory Agencies

ANDREW BARR

The impact of the requirements of regulatory agencies[1] upon the development of accounting and auditing, whether for good or evil, has been the subject of discussion by experienced practitioners, present and past members and employees of such agencies, teachers and students. There is extensive literature on the subject, so much that it seems unnecessary to review it in any detail. However, one such discussion may be cited which covers the subject more broadly than seems necessary today. A past Chief Accountant of the SEC participated in "A Symposium on the Interrelationship of Law and Accounting" which is reported in 36 Iowa Law Review 270 (1951) and in expanded form may be found elsewhere under the title "The Influence of Administrative Agencies in Accounting."[2]

I shall confine my remarks to a discussion of some of the major changes in accounting practice necessary to good financial reporting in a dynamic and expanding economy during a period in which there has been a continual increase in public participation in financing such expansion.

The Securities Acts

The SEC is relatively a newcomer as a regulatory agency when compared with the Interstate Commerce Commission, but the laws which it administers created some consternation in accounting circles when they were proposed in Congress. This was caused in part by the civil liability provisions of the Securities Act and in part by the prospect that the Securities Exchange Act would im-

[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

[2] William W. Werntz, Chapter 4, *Handbook of Modern Accounting Theory*, edited by Morton Backer, New York; Prentice-Hall, 1955.

ANDREW BARR, a member of the Illinois Society of Certified Public Accountants, is the Chief Accountant for the Securities and Exchange Commission. He is a past president of the Federal Government Accountants Association and has been a frequent contributor to accounting publications. This article is adapted from a paper presented on November 11, 1959, at the University of Chicago to a joint meeting of the Chicago Chapter of the Controllers Institute of America and the Illinois Society of Certified Public Accountants. The meeting was co-sponsored by the Graduate School of Business of the University of Chicago and the Illinois Society.

pose uniform accounting requirements on all industry similar to the uniform systems of accounts applicable to railroads.

The only practicing public accountant to testify during the legislative hearings on the Securities Act of 1933 urged that the required financial statements be certified by independent public accountants. Another leading accountant in a memorandum regarding this legislation said:

> "In so far as accounting information is concerned, it seems to me fundamentally important to recognize that the accounts of a modern business are not entirely statements of fact, but are, to a large extent, expressions of opinion based partly on accounting conventions, partly on assumptions, explicit or implicit, and partly on judgment. As an English judge said many years ago when business was far less complex than it is today, 'The ascertainment of profit is in every case necessarily a matter of estimate and opinion.' "[3]

This quotation expresses a point of view necessary to an understanding of financial statements, yet it is difficult to explain to laymen and to some accountants. This difficulty may be an indication that the profession may have over-stressed the importance of accounting principles and failed to emphasize independent objective judgments. The same accountant, in an address on December 6, 1933, before the Illinois Society of Certified Public Accountants here in Chicago,[4] expressed the view that "there is reason to fear that responsible people will refuse to accept the unfair liability imposed on them by Congress under the Act, and will continue to refuse until juster provisions are enacted." He also said that he would "be extremely sorry if the effect of the Securities Act should be to place the distribution of securities and all the work attendant on such distribution in the least responsible hands." By some time in 1934, after some experience with the Commission and its staff,[5] these fears seem to have been dispelled, at least to a considerable extent.

Mr. May was an important witness in the hearings on the Securities Exchange Act of 1934. In these hearings his objections to a uniform system of accounting were developed after his opening remark that "The fact of the matter is that accounting, especially industrial accounting, is essentially a matter of judgment, and you cannot put judgment in strait-jackets."[6] His testimony questions critically the results to be obtained by such regulation as getting "a superficial uniformity which is not real." Elsewhere, Mr. May expressed the hope and expectation that the SEC would "not be led astray by the deceptive promise of uniform accounting,* * *," and would "no doubt use all its great influence to bring about by voluntary action as great a degree of uniformity in different industries as is obtainable, and will insist on consistency from year to year in the accounting of each corporation subject to its regulation."[7] Whether these opinions were influential at the time or not in convincing the Congress that more could be accomplished by cooperative action than by rigid control, the Securities Acts as enacted were expressed in terms of general authority over accounting and have been implemented by regulations specifying the form and content of

[3] George O. May, *Twenty-five Years of Accounting Responsibility*, Vol. 2, p. 52, New York, American Institute Publishing Co., Inc., 1936.
[4] *Ibid.*, pp. 70, 84.
[5] *Ibid.*, p. 113.
[6] *Ibid.*, p. 97.
[7] *Ibid.*, p. 116.

financial statements but not in terms of a uniform system of accounts. However, under the Securities Exchange Act the Commission did adopt bookkeeping requirements for brokers and dealers in securities and does make inspections to insure compliance. The Public Utility Holding Company Act of 1935 authorizes, and the Commission has adopted, uniform systems of accounts for holding companies and mutual service companies; and the Investment Company Act of 1940 in Section 31(c) gives the authority for "providing for a reasonable degree of uniformity in the accounting policies and principles to be followed by registered investment companies in maintaining their accounting records and in preparing financial statements* * *." Rules adopted and presently in effect as to accounting records are expressed in general terms, and the financial statements are governed more specifically by pertinent parts of the Commission's accounting regulations.

Certification Requirements

The SEC, or rather its predecessor, the FTC, for a short time, appears to be the first Federal agency with authority to require certification of financial statements by independent accountants. We should remember, however, that the Federal Reserve Board in 1917 requested the American Institute of Accountants to prepare the bulletin "Approved Methods for the Preparation of Balance Sheet Statements."

As time goes on, we find an increasing number of governmental agencies requiring certified financial statements. The Small Business Administration has recently announced that under its regulations the financial statements of small business investment companies must be audited and certified by certified public accountants.[8] The Rural Electrification Administration, which has utilized its own staff for audits required under the Act administered by it, recently announced that an increasing number of borrowers are being requested by the agency to provide for annual audits of their accounts by C.P.A.'s.[9] Financial reports submitted to the Secretary of Labor for pension funds "must be 'sworn' to by the administrator, or certified by an independent or licensed public accountant."[10]

Bills introduced both in the House and in the Senate pertaining to the "Labor Management Reporting and Disclosure Act of 1959" provided for certification of annual reports by unions; and, although the Act, as finally passed, omitted such an explicit provision, it does give the Secretary of Labor broad authority to require annual financial reports and to establish safeguards to insure their accuracy.[11] The Housing and Home Finance Agency requires independent audits in certain phases of its work.[12] Both staff members of governmental agencies and representatives of the accounting profession have urged Congressional committees to adopt the requirement of certified financial statements for other agencies.

As might be expected, the older governmental agencies such as the FPC, FCC, ICC and the state com-

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[8] 13 CFR 107.302-3.

[9] REA Bulletin No. 465-1, "Audits of Telephone Borrowers' Accounting Records," dated October 31, 1958, Sec. 2.

[10] "Welfare and Pension Plans Disclosure Act," Sec. 306(b), Public Law No. 836, 85th Congress.

[11] Labor Management Reporting and Disclosure Act of 1959 (September 14, 1959), Public Law 86-257, 86th Congress, S. 1555.

[12] News Report, *Journal of Accountancy*, November 1958, p. 16.

missions which exercise accounting regulatory powers over companies through a uniform system of accounts have usually not required independent audits.

Management Services

It seems to me, however, that even in the area where accounting procedures are regulated by agency, the independent audit would provide an objective check on management. In connection with independence and an objective report on management, I would like to inject a word on management services. This is a very popular term today with the small practitioner as well as the national firm. I suggest that the independent accountant in furnishing such services to management keep two questions in mind: first, am I remaining an adviser to management and not entering the decision-making area? second, am I sure that the audit of the financial statements will not involve checking my own work? If both questions cannot be answered in the affirmative, the accountant's independence as to furnishing an objective report on management is in question.

It has been suggested that the rendering of management services sets up a conflict of interests which would render the accountant not independent. Much of the present day emphasis on this subject seems to me to be no more than a renewal of interest possibly engendered by the startling improvements in equipment available to business for handling the accounting and statistical problems created by the growing complexities of business operations. Systems work, cost analysis, budgetary controls and other aspects of business management have long been the province of the public accountant. It could be possible for an accountant to become so deeply involved in performing managerial services for a client that he would lose his objective approach to his audit engagement. In such a case he should concentrate on one activity or the other and not attempt to do both.

In my conservations with accountants and officers of their clients I have been impressed with the number of situations in which the records have been inadequate, nonexistent for some periods, not up to date, and, particularly with respect to inventories, provide no book control over the assets of the companies. In these situations improvement in accounting control is important to investors as well as to management. The need for managerial services in these situations is obvious. The adoption of procedures which would result in better and more timely reporting to management might well be considered a prerequisite to an invitation to the public to entrust its funds to the venture. The need for such services is not limited to unregulated companies. Timely reports for management purposes are just as necessary in regulated companies and may be obtained while at the same time the needs of the regulatory agency are met.

Consideration of the public interest is the basis for our bookkeeping rules for securities brokers and dealers and also is behind our recent amendment of these rules to require that a trial balance be taken at least once a month. Procrastination by broker-dealers is dangerous as the Commission may suspend or revoke a broker-dealer's registration because of his failure to maintain proper records on a current basis or for failure to meet his capital requirements under the

rules. A recent incident demonstrates the necessity for public accountants to be familiar with these rules. A broker who was found by our inspectors to be in violation of our net capital rule defended himself by alleging that his independent accountants had assured him that he was in compliance. The accountant had not made the determination in accordance with the rule. In this type of situation the accountant's work should be a protection to the broker as well as to the customer.

It may be noted here that the audit of a broker-dealer is most effective if made on a surprise basis. Our reporting rules recognize this need by not requiring a fixed reporting date or audits as of the close of the fiscal year. These reports often disclose matters which are followed up by our inspectors. Similar flexibility is provided under the Investment Company Act for certificates on security counts which, in the absence of a satisfactory custodian arrangement, must be made three times during the year, two of which are on a surprise basis with results reported directly to the Commission. I understand that other federal agencies require the independent accountant to render reports which can be used by the agencies in the enforcement of their regulations. More of this type of reporting is being considered.

Most of the work of independent accountants under the Securities Acts involves the rendering of an opinion on the financial statements after completion of an audit made in accordance with generally accepted auditing standards. In the staff review of these statements questions may be raised as to the propriety of the accounting followed or as to the adequacy of the audit. The answers to these questions must be those of an independent accountant rather than as an advocate for the client. Any other course invites trouble for both client and accountant.

Uniformity versus Comparability

The demand for uniformity in financial reporting in unregulated as well as regulated businesses is not new. Many remember the burst of activity in trade associations in the 1920's in developing uniform systems of accounts for industries for the purpose of gathering statistics for the members of the association. Some well-known schools of business participated in this activity and today some accounting firms who have a large number of clients in one line of business publish composite as well as individual operating results with identifications removed. The users of these figures must be familiar with the many variations in operating environment and management policies which could affect the results reported upon a uniform account classification. Except as indicated earlier the SEC has not gone this route but has endeavored to promote the clarification and general acceptance of accounting principles by decisions in individual cases and in cooperation with the accounting profession and other interested groups.

This seems to be an appropriate time and place for me to acknowledge the value to the Commission of the work of the Accounting Procedure Committee of the American Institute of Certified Public Accountants which gave way to the new Accounting Principles Board at the end of August. For the most part the bulletins of the Committee expressed opinions

acceptable to the Commission. On rare occasions exceptions were taken either by letter or in rule making. One of the last acts of the Committee was a clarification (delayed by court action) of Bulletin 44 (Revised). This was necessary in order to fill a gap in the original pronouncement. One of the criticisms of the procedure bulletins has been that the intent is not clear on all points. Similar charges are made with respect to laws and regulations. This results in the development of a body of interpretations by administrators and the courts. A lawyer with much experience in high government office recently wrote that "one can always get an agreed paper by increasing the vagueness and generality of its statements." All of us, I am sure, wish the new Board success in its undertaking to develop clear thinking on the basic postulates underlying accounting principles and in the study of the broad principles of accounting.

The prospect of attaining complete unanimity of thought on accounting seems remote no matter how diligently we try. Notable efforts have been made with respect to principles generally applicable to the determination of income. However, even if we should agree that the matching of costs and revenues is the most important of these (and some would deny it), we are certain to disagree on the details of application. But I do say we should work toward reducing these areas of disagreement.

What should we do about inventories? Verification, or perhaps I should say failure to verify, and pricing of this item has been the most important element in many of our troublesome cases in which financial statements were a factor. The propriety of LIFO as a basis of pricing has been debated for many years—praised by some and denounced by others as a device of the manipulator. Even the effort to get agreement that appropriate disclosure of the effect of this method as compared to others in which more current costs were used was counteracted by allegations that tax cases would be jeopardized or that such a disclosure would be misleading. Recently we have seen a complete about-face on the disclosure question in the desire to use LIFO for the determination of income but FIFO for the balance sheet.

As to depreciation, what possibility is there that uniformity can be attained on depreciation and maintenance accounting even on an industry basis? This is a hard question to answer, but in the meantime improvement in reporting the policies followed will help analysts to reach more reasonable conclusions.

It has been charged that accountants should not tolerate alternate procedures and certify that both are in accordance with generally accepted accounting principles. The Commission recognized in Accounting Series Release No. 4 that this condition exists but at the same time concluded that financial statements which "are prepared in accordance with accounting principles for which there is no substantial authoritative support, * * * will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material."

Stock Options

Let me give you an example of the effort that was made on one subject

which should be amenable to a generally acceptable solution. On the matter of stock options there has been a difference of opinion as to the accounting to be followed and also as to the degree of disclosure necessary in financial statements.

The Commission's present rule on the subject was adopted as an amendment to Regulation S-X in November 1953 [13] after a double exposure of the problem for public comment. Suggestions have been heard recently that disclosure requirements on this subject should be reconciled—the principal point being that our rule requires more detail than is required by Section B of Chapter 13 of Research Bulletin 43 or by the New York Stock Exchange. The Exchange requires disclosure in annual reports to stockholders of the status of options at the beginning and end of the year as to number of shares and price and changes during the year. The Institute bulletin recommends disclosure of the status at the end of the year, including number of shares and price as well as the number becoming exercisable and the number exercised during the year. The Exchange does not express any preference as to accounting procedure. The Institute's current bulletin, as you know, fixes the time of measurement of compensation as the date of grant, whereas before revision the date the option right became vested in the grantee (usually the date when he could first exercise the option) was deemed to be the date when compensation should be measured. I think it is fair to say that the startling results obtained by the application of the earlier version, with which the Commission agreed at the time, to the financial statements in a registration statement led to the revision of the Bulletin.

To the original Bulletin 37 published in November 1948 there were one assent with a qualification and two dissents. Upon revision in 1953 there were two assents with qualifications, and one member of the Committee did not vote.

Our first exposure of the subject under rule making procedures was due to the evident disagreement among corporate and public accountants as to the appropriate manner in which the amounts, if any, to be charged against income representing compensation to recipients of stock options should be determined. The principal point of disagreement was over the time at which the determination should be made. Arguments in suport of the date of grant, first exercisable, and when exercised were so inconclusive that the Commission decided that it would be inappropriate to prescribe a procedure for determining the amount of compensation, if any, of these stock options to be reflected in earnings statements. Instead, the SEC proposed the present rule calling for significant data as to the plan, number, option price, fair value, and total dollar amount of shares at the several dates and a statement as to the basis of the accounting to be followed. Appropriate summaries of this information are suggested.

The example which precipitated this revision was a five-year plan with one-fifth of the granted options becoming exercisable each year. The stock was of $1 par value optioned at $5.00 per share at a time when the market was lower than the option price. As time passed and the company prospered, the market price rose

[13] Accounting Series Release No. 73.

to a high of 33½ during the period covered by the income statements in the prospectus. After some discussion it was agreed that the principles of the bulletin applied but some special treatment was necessary. The "special item" treatment provided for in Regulation S-X was adopted with the result that for the last two periods reported net income of $365,000 for a year and $305,000 for nine months was reduced by $107,000 and $174,000, respectively—amounts equivalent to the excess of fair market value over the option price of shares under the employees' stock options. The differences of $258,000 and $131,000 were captioned Net Income Less Special Item Credited to Earned Surplus.

The summary of earnings included per share figures based on Net Income with reference to a footnote in which the stock option accounting was described. So the bulletin was revised and our rule calls for more comprehensive disclosure than other rules on the subject.

Long-Term Leases

The accounting presentation of long-term leases in financial statements continues to be a controversial topic. Some accountants and business leaders contend that we should include in the balance sheet the capitalized debt under long-term leases to make it comparable with the balance sheets of those companies using long-term debt to finance the acquisition of similar facilities. A study in 1948 by the staff of the Commission on this subject led to a proposed Accounting Series release. After a discussion with representatives of the Institute, it was decided that an Accounting Research Bulletin would be issued, and Bulletin No. 38 (now Chapter 14, Accounting Research Bulletin No. 43) on "Disclosure of Long-Term Leases in Financial Statements of Lessees" was released by the Committee on Accounting Procedure in October 1949.

Prior to the issuance of Bulletin No. 38 we had been requiring certain information on long-term lease rentals in Schedule 16 dealing with supplementary profit and loss information.[14] In the 15th Annual Report to Congress[15] we stated the policy being followed as to when leased property and any related liability should be shown in the balance sheet. Three types of long-term leases, depending upon the terms of the contract, were outlined:

(1) Simple lease arrangements containing no provision for acquisition by the tenant of title to the property.
(2) A lease which involves the purchase or repurchase of the property by the lessee, and provides that the periodic payments made under the agreement will be applied against the purchase price of the property.
(3) A contract incorporating an agreement which permits but does not obligate the lessee to acquire title to the property either during the life of the lease or upon its termination.

Supplemental information in a balance sheet footnote concerning lease obligations assumed and annual rentals is now considered adequate disclosure for simple long-term lease arrangements. Those leases which are clearly purchase or repurchase contracts should be shown at their full contract cost, less appropriate allowance for depreciation, on the

[14] Instruction 5 to Rule 12-16 of Regulation S-X required prior to 1950 a statement of the aggregate annual amount, if significant, of the rentals upon all real property now leased to the registrant and its subsidiaries for terms expiring more than three years after the date of filing, and the number of such leases.

[15] 15th Annual Report, Securities and Exchange Commission (1949), pp. 181-182.

asset side of the lessee's balance sheet, with the liability under the purchase contract reflected under an appropriate caption on the liability side. This treatment is in accord with the recommendation in Chapter 14 of Accounting Research Bulletin No. 43. One has to go beyond the form of those contracts in which acquisition of title is permissive and determine whether, in substance, the lessee actually intends to acquire the property. Some factors to be considered in making a decision are:[16]

"1. Whether the rentals are to be applied against the purchase price, and if so, whether they are out of line with rentals under leases not containing acquisition provisions;

2. The estimated value of the property at the time the purchase option becomes exercisable as compared with the agreed purchase price, if any;

3. Whether the contract provides for an extension of the lease period, and the amount of the rentals to be paid during the extended period."

In some of the articles I have seen on long-term leases the writers have prescribed the balance sheet capitalization of all long-term leases, regardless of the terms of the contract. While there may be some merit in capitalizing all long-term lease commitments, there are also certain grave dangers, and thorough consideration should be given to all factors before departure from present day accounting principles and practices. One has only to recall some of the mining cases of the 1930's to realize that recording leased assets may be used to inflate the balance sheet.[17] These cases will also indicate that there is more to be considered than the mere reflection in the balance sheet of a liability for future expense payments even though it is an item which most likely will be paid. A recent article by a representative of an investment banking concern, however, has indicated that an influential group, institutional investors, does consider the impact of long-term lease capital by including it in a recast statement. Perhaps we should give attention to requiring disclosure of any additional data necessary for a more accurate recasting.

[16] *Op. cit.*, pp. 181-182.

[17] *American Terminals & Transit Co.*, 1 SEC 701; *Canusa Gold Mines*, 2 SEC 548; *Franco Mining Co.*, 1 SEC 285; *Great Dike Gold Mines*, 1 SEC 621; *Poulin Mining Co.*, 8 SEC 116.

Conflict of Jurisdiction

The Securities and Investment Company Acts are designed primarily for the protection of investors. The Holding Company Act charges the Commission with the protection of investors and consumers. Other federal and state regulatory agencies have a primary interest in consumers and then an interest in investors as a source of financing. It is inevitable, perhaps, that some commissions would adopt conflicting orders and regulations relating to accounting matters. Even the Uniform Systems of Accounts approved by the National Association of Railroad and Utilities Commissioners are not uniformly adopted by the respective state regulatory agencies. Specific changes in some of the accounts or in their application will be made by a state agency to conform with its regulatory philosophy.

An example of how regulatory agencies may differ on accounting matters as they affect the consumer or the investor groups is in the treatment of "plant acquisition adjustments" in rate cases. Plant acquisition adjustments represent the difference between the cost to the account-

ing company of property acquired as an operating unit and the cost of such property when first devoted to public service. The several federal regulatory commissions and a number of state commissions exclude "plant acquisition adjustments" from the rate-base and exclude the periodic charges for amortization of such amounts from the "cost of service." Such commissions are said to use the "original cost" concept in determining the rate-base. Other commissions may include the cost of the property to the company in the rate-base and include the periodic charges for amortization of such cost in the "cost of service." Such commissions usually are operating under the "fair value" concept of the rate-base. A few state commissions in arriving at the "fair value" rate-base give consideration to the estimated "reproduction-cost-new" valuation of the plant assets.

Regulatory agencies have required the classification of excess costs to the acquiring utility over original cost as well as any excesses of original cost over acquisition cost to be recorded in the same account, and the net balance of this account to be added to or deducted from the plant account depending on whether a net debit or credit balance results. A common procedure in consolidated statements of unregulated companies has been to report debit excesses as consolidated goodwill and credit excesses have often been added to capital surplus.

Of outstanding contrast is the general policy of the regulatory agencies to require periodic amortization of the Acquisition Adjustment Account or the immediate write-off to earned surplus. In unregulated companies no amortization program for intangibles of unlimited life is required by Accounting Research Bulletin No. 43, although the bulletin does state that the intangibles "should be written off when it becomes reasonably evident that they have become worthless." Even when goodwill is thus written off, according to the bulletin, the charge does not need to be made against income where "its effect on income may give rise to misleading inferences." However, in reports filed with the Commission these charges have been deducted from income (as special items if material in amount). Seldom is any action taken to write off credit excesses.

That the policy of reporting the excess of underlying equity in net assets of subsidiaries over the cost of the parent's investment therein as consolidated capital surplus is fairly common is evident from reviewing recent issues of *Accounting Trends and Techniques* and cases in our files. Accounting Research Bulletin No. 51, recently promulgated by the Committee on Accounting Procedure, does not condone this practice. Paragraph 8 provides:

> "Where the cost to the parent is less than its equity in the net assets of the purchased subsidiary, as shown by the books of the subsidiary at the date of acquisition, the amount at which such net assets are carried in the consolidated statements should not exceed the parent's costs. * * * A procedure sometimes followed in the past was to credit capital surplus with the amount of the excess; such a procedure is not now considered acceptable."

The bulletin further provides for allocation of the excess of equity in net assets over investment cost to the specific assets to which it is attributable with corresponding adjustments of depreciation or amortization. In addition "in unusual circumstances

there may be a remaining difference which it would be acceptable to show in a credit account, which ordinarily would be taken into income in future periods on a reasonable and systematic basis.''

The amortization requirement for consolidated goodwill is not so definite. Paragraph 7 of Accounting Research Bulletin No. 51 does indicate that portions of the excess cost of investment over equity in the net assets of a purchased subsidiary attributable to tangible assets and specific intangible assets should be allocated to them. This paragraph also states that depreciation and amortization policies should be restated to provide for the absorption of the allocated excess over the remaining life of the related assets. Any difference remaining is carried as an intangible in the consolidated statement and the only provision for eliminating such item is found in Chapter 5 of Accounting Research Bulletin No. 43. It seems that any intangible that remains from consolidation may represent a payment for excess earning power and should be amortized against future earnings resulting from the operations of the subsidiary. Does the publication of Accounting Research Bulletin No. 51 suggest a reexamination of currently accepted practice with respect to good will? Accounting Series Release No. 50 expresses a preference for writing off good will through timely charges to income.

Progress in Financial Reporting

Breaking the life of a corporation down into periodic intervals of one year or less will probably continue to be an underlying cause of many of the basic problems of accountants. We are all aware that income can be measured fairly accurately for the whole life of a joint venture or other enterprise; but as we attempt to shorten the period for reporting operations the more difficult our task becomes and it is attended by a widening of the limits of fair reporting.

At one time the Securities and Exchange Commission required quarterly reports of revenues and sales. In October 1952 the Commission proposed revised rules calling for detailed quarterly statements of profit and loss and earned surplus. These rules were not adopted as they met strong opposition from accountants and registrants. About a year later the requirement of quarterly reports of sales and revenues was dropped.

The Commission believed, however, that some interim information was desirable and in addition believed that there was a great demand for frequent reporting of business operations from other governmental agencies, business research units, financial analysts and bankers, universities and other parties interested in business conditions. At the behest of financial analysts and others, we started preparation in 1954 to request comments and suggestions from interested parties relative to reviving our interim reporting on a semi-annual basis. Unfavorable comments received covered a wide variety of subjects including the misleading effect that might be inferred because of seasonal variations, year-end adjustments due to difficulty in allocating revenues and expenses to short periods, need for taking additional physical inventories, the fear of liability of company management in submitting unaudited reports, the unfairness to listed companies as opposed to non-listed ones,

and the increased cost both to registrants and the government.

After a public hearing in March 1955 the Commission required the filing of certain summarized earnings data on a six-months basis. The hardships accompanying the determination of such data were noted, particularly the need for relying on reasonable estimates, and in recognition thereof the Commission exempted such reports from the liability for misleading statements under Section 18 of the Securities Exchange Act.

This mid-year report is essentially a disclosure of sales and revenues, extraordinary items, income taxes, and net income or loss. As far as I can tell, this has been a satisfactory compromise between the groups who did not favor any interim reporting and those who urged that quarterly profit and loss statements be filed. With the great diversification in operations which has developed, it may be that some breakdown of sales beyond the present requirement of separation of service revenue of over 10% of the total should be required. In Form S-1 we do require disclosure of sales by product lines which contribute 15% or more of the gross value of business done.

It is interesting in this connection to note that reporting sales of major product lines has recently been advocated in a suggested revision of the Company Laws of Ghana.[18] Another unusual item in the Proposed New Law of Ghana is the reporting of liabilities at the amount repayable "less where appropriate, a reasonable deduction for discount until that date."[19] The proposed law, while noting in some places that recognition had been given to SEC requirements, provides for upward restatement of assets by action of the board of directors and in this respect varies drastically from our practice of not permitting such upward restatements. However, the Ghana Law requires the disclosure of original cost. The provision with respect to upward restatements is not clear as to whether depreciation need be taken on the higher amount although dividends may not be paid from the appreciation surplus.[20] Such surplus may be transferred to stated capital.

I mention this Ghana report as evidence of the improvement in financial reporting in foreign countries. While the offering of foreign securities in the United States is limited, there is evidence of a growing interest in our financial markets and in our requirements as to accounting and auditing. The arrangement of affiliations with foreign accounting firms by American accounting firms is further evidence of the movement of American capital abroad.

The appearance of Mr. J. Kraayenhof of the Netherlands, former President, 7th International Accounting Congress Commitee, and Past President, Netherlands Institute of Accountants, on the program of the recent annual meeting of the American Institute is further evidence of our interest in accounting developments abroad. Mr. Kraayenhof made a strong plea for "the widest acceptance of a uniform set of intelligible rules," but at the same time warned that rigidity in the fixing of accounting principles would not result in real comparability but "would only lead to the risk of the shadow being ac-

[18] *Proposed New Company Laws of Ghana Committee for Revision*, General Comment No. 8 on Financial Statements, p. 337.

[19] *Op. Cit.*, p. 330.

[20] *Op. Cit.*, p. 79.

cepted for the substance." In support of his endorsement of international uniformity in accounting principles he asked "What good reasons can be upheld, other things being equal, for adopting different principles in various countries as to the valuation of stocks, as to methods of depreciation, as to whether or not reserves are concealed in the accounts or whether provisions are to be made for deferred taxes?"

Mr. J. S. Seidman, newly elected President of the American Institute of Certified Public Accountants, announced in a press conference on the day of his election that he would press for action on three major challenges, one of which was standardization of international accounting principles. I can assure you that the SEC is directly concerned with the success of this project and will participate in any appropriate way in assisting the accounting profession in this country to meet this challenge.

Progress in Accounting

I have cited examples of efforts made by the accounting profession and the SEC to keep pace with the business world in the application of accounting principles to new conditions. A basic requirement throughout has been to reach a fair presentation of financial condition and results of operations. Some critics contend that the response to a need for change is not quick enough. Others insist that new ideas must be observed and tested by experience before being recognized as generally accepted and applicable to all similar situations. During the period of observation, alternative solutions to accounting and disclosure problems develop and when it is proposed to designate one method as having met the test for general acceptability resistance to change is based upon the grounds that a decision should have been made before permitting the alternative methods to become established. What may be considered progress by some is deemed by others to be interference with vested rights. The former group sometimes point to government agencies such as the SEC with the charge that we discourage needed changes in accounting procedure by a too rigid insistence on conformity with our rules and regulations, the Accounting Research Bulletins or other formalized accounting standards.

Progress in the field of accounting is facilitated by representatives of various professional groups meeting and exchanging ideas in conferences, through correspondence and through professional publications. The SEC finds it particularly necessary to keep informed of the changes and new developments in the field of accounting theory and auditing. As changes and new developments occur in the business world, the financial statements of the several thousand commercial and industrial companies required to file statements with the Commission are modified to keep pace with a dynamic economy. A glance at some of the statements filed in the 1930's will reveal many striking contrasts when compared with those being filed today.

THE CASE OF THE MISSING MEMBER

Louis M. Kessler

The New Member CPAs

The membership of the Illinois Society of Certified Public Accountants is composed of something less than 100% of the CPAs in Illinois. What about the non-member CPAs? When did they become CPAs? In what occupations are they engaged? To what other associations do they belong? How do they feel about membership in professional organizations? Do they know about the Society's activities and programs? Have they been invited to join the Society? Do they know someone in the Society? What specific reasons do they have for not joining?

These are some of the questions for which answers were sought in a letter sent by Dr. Lloyd Morey to about 1,000 non-member CPAs believed to be in Illinois and for whom the Society had reasonably accurate addresses. Over 400 replies were received, unsigned. Of these, however, some 80 respondents gave their names and addresses on a post card and asked for additional information about the Society. They received a folder containing extensive information and were especially invited to attend the Tax Conferences. A general invitation to the Tax Conference was also sent to the 1,000 on the original mailing list. The Membership Committee is making personal contact with the 80 non-members who asked for additional information. The more than 400 replies to the questionnaire were coded in the Society office, and key punching and tabulating were done through the courtesy of Society member Charles Freeman of the National Calculating Service, Inc. Results were submitted to Dr. Morey and to the Membership Committee.

Occupations

Replies postmarked outside Illinois were excluded from the tabulations as were those that did not indicate an occupation or the year of receipt of the CPA certificate. The occupations of the remaining 365 were as follows (divided between Metropolitan Chicago and Downstate):

LOUIS M. KESSLER is a partner of the firm Alexander Grant & Company. He has long been active in the work of the Illinois Society. Currently, he is the Chairman of the Membership Committee and is the Senior Vice-President nominee of the Society. He also currently is a member of the Executive Committee of the American Institute of Certified Public Accountants.

	Total	Metropolitan Chicago	Downstate
Public Accounting[1]			
Individual Practitioner	59	48	11
Partner	12	11	1
Manager or Principal	3	3	
Staff Member	54	52	2
Total—Public Accounting	128	114	14
Non-Public Accounting			
Commerce and Industry	145	130	15
Education	17	16	1
Government	35	35	
Other	40	36	4
Total—Non-Public Accounting	237	217	20
Total	365	331	34

[1] Eight individual practitioners and three staff members also checked a non-public accounting occupation. These eleven are included in public accounting in the tabulations.

Interest in Professional Associations

As to their personal feelings about membership in professional associations, the respondents were asked to check one of the following:

A. Very important to me.
B. Moderately important to me.
C. Neither important nor unimportant to me.
D. Not at all important to me.

The number of answers given in each of the four categories was as follows:

	A	B	C	D	No. Answer	Total
Occupations in:						
Public Accounting	28	67	26	5	2	128
Non-Public Accounting	44	118	56	16	3	237
Total	72	185	82	21	5	365

By giving a weighting of 100%, 75%, 50% and 25% to the answers A, B, C and D, respectively, and omitting those who gave no answer, the weighted averages indicated the following degree of interest:

Occupations in:	
Public Accounting	73.4%
Non-Public Accounting	70.3%
Total	71.4%

The respondents were then asked the following four questions:

1. I feel I do——do not—— have an obligation to belong to professional organizations or associations.
2. Have you ever been informed of the Illinois Society of CPA's activities and programs?
3. Have you ever been invited to join the Illinois Society?
4. Are you personally acquainted with a member or members of the Illinois Society?

Excluding those few who gave no answer, the percentages giving affirmative answers were as follows:

	1 Do	2 Yes	3 Yes	4 Yes
	%	%	%	%
Occupations in:				
Public Accounting	70	87	89	91
Non-Public Accounting	62	84	89	87
Over-all	65	85	89	88

Membership in Organizations

Organizations to which respondents currently belong were reported as follows:

	Occupations in Public Accounting	Non-Public Accounting	Total
American Institute of CPAs	36	40	76
National Association of Accountants	6	22	28
Controllers' Institute	..	12	12
Illinois Society of CPAs[2]	2	1	3
American Accounting Association	4	8	12
Institute of Internal Auditors	1	4	5
Other	13	31	44

[2] Any questionnaire is likely to yield some peculiar answers. Since these three were all in the younger group, perhaps they were filling out an application.

In groups according to year of becoming a CPA, the respondents reported membership in the several organiations as follows:

	Year of Receipt of Certificate			
	1950–9	1940–9	Prior to 1940	Total
American Institute of CPAs	39	19	18	76
National Association of Accountants	19	3	6	28
Controllers' Institute	2	2	8	12
Illinois Society of CPAs[2]	3	..	..	3
American Accounting Association	4	2	6	12
Institute of Internal Auditors	2	2	1	5
Other	14	10	20	44

Interest in Specific Organizations

The respondents were next asked to check which of these organizations they felt they *should* belong to. Results were reported as follows (after eliminating those who checked that they did belong to an organization but also checked that they *should* belong to that organization, thus leaving in the following tabulation those who do not belong, but feel they should belong to the organizations indicated):

	Year of Receipt of Certificate			
	1950–9	1940–9	Prior to 1940	Total
Occupations in Public Accounting				
American Institute of CPAs	36	3	2	41
National Association of Accountants	2	..	..	2
Controllers' Institute	..	1	1	2
Illinois Society of CPAs	61	8	8	77
American Accounting Association	7	..	..	7
Institute of Internal Auditors	..	..	..	..
Other	..	1	..	1
Occupations in Non-Public Accounting				
American Institute of CPAs	43	9	4	56
National Association of Accountants	9	..	..	9
Controllers' Institute	26	8	3	37
Illinois Society of CPAs	60	17	9	86
American Accounting Association	6	..	1	7
Institute of Internal Auditors	8	1	2	11
Other	4	..	1	5

Of those for whom replies were tabulated, 163, or about 45%, said they felt they *should* belong to the Illinois Society of CPAs. These 163 listed the following occupations:

	Year of Receipt of Certificate			
	1950–9	1940–9	Prior to 1940	Total
Public Accounting				
Individual Practitioner	20	6	5	31
Partner	2	2	3	7
Manager or Principal	2	..	..	2
Staff Member	37	..	..	37
	61	8	8	77
Non-Public Accounting				
Commerce and Industry	37	12	6	55
Education	7	..	..	7
Government	11	4	1	16
Other	5	1	2	8
	60	17	9	86
Total	121	25	17	163

The Old and the Young

The Membership Committee was particularly interested in knowing the reactions by age groups, or length of time the respondents have had their CPA certificates. The following tabulation compares replies received with interest in joining the Society, by groups according to year of receipt of certificate:

	Replies tabulated		Those who feel they should belong to Illinois Society	
	No.	%	No.	%
Year of receipt of certificate				
Prior to 1940	72	19.7	17	10.4
1940–1949	69	18.9	25	15.4
1950–1959	224	61.4	121	74.2
Total	365	100.0	163	100.0

The course is clear. To bring the greatest number of CPAs into the Society, the Membership Committee should maintain continuous contact with young CPAs. If an individual does not join the Society by the time he has had his certificate for ten years, the prospects of his ever doing so are not encouraging.

Reasons for Not Joining

Finally, the respondents were asked to check one or more reasons why they have not joined the Illinois Society of CPAs. Results, by occupation, and by year of becoming a CPA, are as follows:

		By Occupation		By Year of Certificate		
	Total	Public Accounting	Non-Public Accounting	1950–9	1940–9	Prior to 1940
Not in public accounting	174	3[3]	171	97	37	40
Practicing law	20	2	18	14	2	4
Retired	10	5	5	2[4]	..	8
Dues	96	32	64	65	16	15
Admission fee[5]	75	18	57	47	15	13
Belong to AICPA	39	14	25	17	7	15
Belong to other societies	45	14	31	11	11	23
Not interested in Illinois Society	52	24	28	32	9	11
Other	100	47	53	73	18	9

[3] We repeat, any questionnaire is likely to yield some peculiar answers.
[4] These two either got their certificates late or retired early.
[5] The Society has no admission fee. This was a "loaded" question to see how much more education is needed on the subject.

Perahaps one of the "other" reasons may be described as "inertia." The following is quoted from Dr. Morey's letter with which the questionnaire was enclosed.

> "The value of each and every CPA certificate depends upon our mutual ability to safeguard the high standards of our profession. Since each of us cannot spend the time we would like to defend our CPA certificates, we are fortunate to have the Illinois Society of CPAs to do this for us. The Society maintains constant legislative vigilance to guard against any cheapening of our certificate.
>
> As a past president of the Society, I am personally very interested in its activities and have agreed to direct this research study into certain aspects of recruitment of new members. The purpose of this study is to determine the attitudes toward this organization and reasons for a lack of participation by some CPAs. This is NOT a membership appeal. This is a study designed to elicit answers to pertinent questions in the area of membership."

We have the results of the research study. The rest is up to us. Membership promotion is a job for *all* Society members—not for the Membership Committee alone.

BANK CONFIRMATIONS—DO'S & DON'TS

W. Gale High

While experience with the use of the standard bank confirmation form has proven its usefulness, a reappraisal of the entire area of bank confirmations by the Illinois Society's Committee on Cooperation with Bankers and other Credit Grantors indicates a need for certain procedural changes.

This committee, in cooperation with a committee of the Chicago Conference of NABAC, The Association for Bank Audit, Control and Operation, has prepared and distributed a leaflet entitled "Bank Confirmations—Do's and Don'ts for Certified Public Accountants," a digest of the recommendations treated in more detail in this article. The sequence of the items in the leaflet is not intended to convey any special significance; however, the leaflet does present those items which, in the opinion of the bank representatives, were of most immediate concern to banks.

Introduction

The number of confirmation requests received by banks is constantly increasing and is admittedly an expensive and time-consuming operation. Fortunately, the increasing adoption of fiscal years ending other than December 31 has eliminated to some extent the widespread fluctuations of volume previously encountered. This development has made the requests for confirmations a year-round problem for banks.

Bankers recognize the importance of confirmations in the preparation of the audited statements submitted by customers requesting credit and are willing to answer any "reasonable" request for information from public accountants. Many banks recognize that every confirmation answered satisfactorily is in effect a direct confirmation of the records of the bank. The cumulative effect of such confirmations, where adequate controls are established by the bank, can be an important element in its internal audit program.

Any improvement in current bank confirmation procedure would be of direct benefit to all interested parties: the public accountant, the bank, and the client depositor.

The General Problem

There are certain aspects of the problem of bank confirmations which have relatively little bearing on the

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form itself. However, these aspects are important in any search for means to improve the present confirmation procedure. The following considerations are important:

(1) *Advance planning of the audit engagement should include the confirmation program.* Banks would prefer, in most cases, to have the request on hand before the "as of" date. This allows more effective scheduling and planning of the bank work load. Also, current information is much easier to confirm.

(2) *Bank confirmations should be reviewed promptly upon their receipt by the accounting firms, if practicable.* This permits corrections or clarifications to be made on a current basis while the information is readily available.

(3) *Telephone requests for confirmation, if made at all, are to be followed up with a written request.* Fortunately, such requests are not a large percentage of the total. The bank must be assured that the release of information is authorized and that the proper person receives such information. For protection of all parties concerned, a bank usually insists upon written requests for confirmation, properly authorized.

(4) *Requests for "cut-off" bank statements in a separate letter are desirable.* Since, in most banks, these are handled by a different section than the confirmation request, a separate letter saves times and helps prevent the omission of a request.

Problems More Specific to the Form

In their attempt to be of service to public accountants through furnishing bank confirmations, bankers have noted the following problems arising from the present bank confirmation form:

(1) *Banks receive many forms in which the exact name of the customer and the account title are not shown.* Depositors frequently have several accounts with a bank. A complete listing of all accounts, showing the account titles exactly as they appear on the bank account names often do not reveal affiliations. Inaccurate listing of account titles may lead to a reply that, according to bank records, no such account exists.

Some accountants have expressed the opinion that disclosure of account titles defeats, in part, the purpose of their request. They prefer to ask for "all accounts" thus seeking disclosure of unrecorded client assets. However, as pointed out previously, the bank normally will interpret the authorization as limited to the capacity of the signer. If John Doe signs the confirmation request as Treasurer of the XYZ Company, then only accounts in that company name will be confirmed. Normally, no search is made of the bank records to determine beneficial interests, if any, in other accounts. It was the opinion of the majority of the committee members that the location of unrecorded assets could be accomplished by other feasible auditing techniques.

(2) *Two forms are necessary for bank processing if all information is required for two different dates.* Where balance only information is desired for one date the form should clearly so indicate. Often forms are received showing two "as of" dates with no indication of the actual audit date. Unless the accountant indicates that balances only are required for one date, records throughout the bank must be re-checked in order to complete the entire standard form as of the additional date.

(3) *Banks are requested to authenticate deposit slips, furnish duplicate deposit slips, furnish dates of credits prior to and subsequent to the audit date, and occasionally to permit the public accountant to compare the depositor's duplicate deposit slip (authenticated by the bank) with the original deposit slip from the bank's records.* Apparently, from the number of requests received, many accountants believe that each deposit is proven by the bank in detail. Actually, this is not so. General procedure results in a proof of currency and of total checks. Therefore, the only confirmation a bank can make of a deposit, usually, is that of total. The fact that the details on the original and the duplicate deposit slips agree is no assurance that the items listed were the actual items received by the

bank. Most banks are aware of and in sympathy with the desire of the accountant to assure himself that lapping, kiting, or other manipulations of cash are not indicated by the records of the client under audit, but they often are unable to make the confirmation of specific items requested.

Many accounts in banks are what are known as "concentration accounts." In such accounts it is difficult to locate a deposit without knowing the date of the credit. Inasmuch as receipted copies and supporting data are sent to the depositor, properly authenticated by the bank, prompt and accurate certification will be expedited if such copies are returned with the request for additional information.

(4) *Confirmation of securities held, usually referred to as "safekeeping," presents recurring difficulties.* Although many bank customers do have items in safekeeping with the bank, the proportion is not such as to warrant inclusion of this request as part of the standard form.

Unless there is specific indication of safekeeping, this request should be omitted. Here again, the timely receipt of the request is important, since it is time consuming and difficult to reconstruct the bank records for an audit date some time in the past.

(5) *"Safekeeping" does not ordinarily encompass commercial paper held for credit to a customer's account at maturity, or "collection" items.* Frequently an accountant uses the term in an all-inclusive sense. Since bank records on commercial paper generally are on the basis of maturity and actual confirmation of collection items is infrequent, these areas are not covered in the usual confirmation. If the accountant wishes to have such items verified, a list should be furnished to the bank giving full description, due date, collection number, etc.

(6) *While the standard form is extremely useful, it has certain limitations and is not practical in every situation.* A limited amount of additional information can be requested in a continuation of the standard form under items 5, 6, 7, etc. However, it is not recommended that the form be printed for the accountant's own use with such additional items unless the items appear with a box for checking when it is desired that the bank comply with the item.

(7) *The public accountant should contact the bank directly (the department and person responsible for confirmation work) in reference to all questions concerning reporting, omissions, timing, etc.* Unless this approach is followed, the solution of normal routine problems handled daily on a cooperative basis between the public accountant and the bank's staff is frequently complicated unnecessarily because of a lack of effective communication between the two parties and not because of a lack of cooperation.

Summary

The standard bank confirmation form is a useful, well designed form. Its widespread adoption has permitted banks to cope more satisfactorily with the increasing volume of requests for information from Certified Public Accountants. However, as indicated, problems have arisen in this area which cooperative effort can solve. The publication of the leaflet on Do's and Don'ts is a concrete example of the results of such effort.

LUNCHEON COMPANIONS AT THE 1959 ANNUAL MEETING

The Honorable William G. Stratton
Governor of the State of Illinois

Mr. Paul F. Johnson, President (1958-59)
The Illinois Society of Certified
Public Accountants

A BANQUET SCENE AT THE 1959 ANNUAL MEETING

Plan Now to Participate

in the

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The Drake Hotel, Chicago, Illinois

RELAXATION

FELLOWSHIP

PROFESSIONAL DEVELOPMENT

Presentation of a Tax Case Before the Appellate Division – A Practitioner's View

J. A. Bernauer

The assistance to our clients in determining their federal tax liabilities represents not only a real challenge to our professional competence as CPAs, but also one of the most rewarding opportunities for service available to us. One of the most appealing aspects of this opportunity is that accomplishment can be measured in terms of dollars. In our present era of high tax rates, there are few matters in which business men have greater interest than the amount of tax they owe to the Government. Consequently, a piece of good workmanship in this area represents a unique step toward the establishment of the kind of relationship we are constantly striving to achieve with clients.

This opportunity, however, carries with it certain responsibilities—moral and technical. A review of our moral responsibilities was recently published in the April issue of *The Journal of Accountancy* in articles by Mr. Charles R. Lees, a CPA, Mr. Norris Darrell, an eminent attorney, and Mr. Clifford Stowe, formerly Assistant Commissioner of the Internal Revenue Service. These articles are well worth your time in reading. In my judgment, our technical responsibility implies the same high standards of competence set forth in the American Institute pronouncement on "Generally Accepted Auditing Standards." The responsibility of protecting your client's rights and privileges in tax matters certainly includes the duty to urge the interpretation and application of the taxing statutes to the facts at hand in a manner most favorable to your client. Nevertheless, our responsibility to ourselves and to our profession demands that in all of the dealings with the Government, we preserve our reputation for integrity.

I propose to review the matter of handling a federal tax dispute before the Appellate Division of the Internal Revenue Service from the practitioner's point of view. Before we proceed with a consideration of the actual problems involved, it might be well to

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consider the steps that have occurred before we reach the Appellate Staff:

1. A return has been filed.
2. A Revenue Agent's examination has been completed with resulting proposed adjustments unfavorable to your client.
3. The taxpayer has been invited to an informal conference with the Revenue Agent's Group Supervisor.
4. An informal conference has been held with an unsatisfactory proposal or the informal conference has been by-passed.
5. Your client has received a letter from the District Director's office proposing certain adjustments. This letter has also informed him that he may sign a waiver agreeing to the proposal, or he may file a protest within 30 days against the proposed determination.
6. The taxpayer's file is temporarily in the custody of the Review Section of the District Director's office, awaiting receipt of the protest and then to be transferred to the Appellate Division.

At this point we are ready to examine the problems that face you in this engagement, and I believe that they can be classified into two principal parts:

1. Analysis and preliminary considerations.
2. Preparation of the actual protest, and conference for negotiation of a settlement of the dispute.

Let us examine these areas in just that order.

There is an old saying that the first step in the solution of a problem is to determine just what it is. This may seem to be a simple matter, because the Revenue Agent is obliged to state the basis of his proposals in the report of examination received with the 30-day letter. However, unless you have actually participated in discussions with the examining officer or in the informal conference and have a clear conception of what evidence the agent has examined and how he formed his conclusions, there is considerable work to be done.

The report submitted to the taxpayer by the Revenue Agent is only a summary of a much more comprehensive report with working papers and schedules submitted to the Review Section with the taxpayer's file. The report submitted to the taxpayer frequently contains a general or vague statement that a certain item doesn't qualify as an ordinary or necessary business expense within the provisions of Section 162, or perhaps a more profound statement that evidence was lacking that an item paid was actually an obligation of the corporation; therefore, it does not qualify as a deductible item.

It has also been my experience that you cannot always rely upon the client's or corporate officers' conception of what the actual issues are. At times the lack of effective communication and mutual understanding between the agent and taxpayer is surprising. Less frequently, but on occasion, this lack of understanding may even exist as between the Revenue Agent and a member of your staff. Therefore, it is highly desirable for the man responsible to discuss the issues with the Revenue Agent before the 30-day letter is prepared. On occasion, I found it desirable to prepare a memorandum, summarizing the Revenue Agent's position on unagreed items and review this with him to pin point, if possible, his understanding of the facts and applicable provision of the Internal Revenue Code, regulations, cases and rulings. At this stage of development, the Revenue Agent has taken on the role of an adversary; therefore, it is important to determine what he believes to be the weakness in your client's position.

In the great majority of unagreed issues, which can be successfully overcome, there has been an imperfect determination of the facts by the examining officer, rather than a lack of knowledge on his part of the Code or regulations. A re-examination of the facts surrounding the transactions challenged by the Revenue Agent should be made. This should include not only the evidence examined by the Revenue Agent, but any other evidence available. Most clients like to have the Revenue Agent's visit as brief as possible and with a minimum of questions raised. This is understandable. I am sure that there are very few instances in recorded history in which a visit from the tax gatherer or his representative was a joyous event. However, frequently this results in the Revenue Agent obtaining a partial understanding of a transaction or a distorted idea of what actually happened. As expert accountants, our skills in determining and verifying facts especially qualify us to marshal pertinent evidence. In conducting a proceeding before the Appellate Division, there is the opportunity to use these skills to the utmost.

Having gathered and reviewed all of the related facts and evidence, the tax accountant is now ready for his technical research. This should develop the merits of your client's position. This research will not only rebut or confirm the particular basis of the Revenue Agent's proposal but should also bring to light other aspects of the issues which the taxpayer's representative should be aware of in this proceeding.

In his examination of a tax return, the Revenue Agent brings with him the advantage of hindsight. This hindsight should not only be used in favor of the Government, but should also be applied in favor of the taxpayer to determine the correct tax liability for the periods reviewed. Nevertheless, we should recognize the "facts of life." By the very nature of his position, I believe he has a greater interest in protecting the Government's revenue than in the rights or privileges of the taxpayer. In this preliminary stage, therefore, it is essential to review and consider the entire return, with the same benefit of hindsight, to uncover any basis for offsetting items. This review may even disclose potential issues not challenged by the Revenue Agent in his report. Nevertheless, it is important to be aware of any inherent weaknesses not only with respect to items which are to be protested but latent possibilities as well. The Technical Adviser of the Appellate Division will review the taxpayer's entire file before any conference and he will ask questions not adequately covered in the Agent's report to him. I do not believe we have any obligation to disclose controversial issues not in the report, but we have a duty to give frank and honest answers to inquiries made.

Having performed a careful job of determining the critical and potential issues, the facts bearing upon the issues, as well as the task of technical research, it is well to have a frank evaluation of the probable or possible outcome with your client. What are the chances for a satisfactory conclusion in the Appellate Division? Are our problems primarily those of a proper understanding or presentation of the facts at hand, or are they concerned with a very technical interpretation of the Code?

In this connection, the advisability of discussing the entire matter with

your client's regular legal counsel should be considered. Circumstances obviously vary, depending upon the relationship between your client and his lawyer and the particular lawyer's experience in tax matters. If there is a good possibility that it may be necessary to litigate to get proper relief for your client, it is imperative that there be good communication and cooperation between the tax accountant and the attorney, even though the accountant is primarily responsible for the Appellate Staff proceeding. Any evidence introduced in this proceeding will become a part of the record; it is only prudent, therefore, for the accountant to keep the attorney well informed if this is the case. If litigation is necessary, the burden of overcoming the Government's determination will rest with the attorney. He should have full knowledge of what happened before.

Should your taxpayer-client avail himself of the Appellate Division proceeding following the 30-day letter or allow the District Director to issue a statutory notice in the form of a "90-day letter"? I understand that in recent years, there has been a tendency by some tax practitioners (both lawers and accountants) to recommend a by-pass of the 30-day Appellate conference. The alleged advantages to this strategy are twofold:

1. Upon issuance of the statutory notice, the issues become fixed; that is, Government's representatives are now barred from raising new issues.[1] Nevertheless, the taxpayer may in his petition to the Tax Court contend for additional adjustments favorable to him.
2. It is the opinion of such practitioners that there is less skill in the District Director's office than there is in the Regional Commissioner's office. Therefore, the task of identifying the issues in a report is best left with the District Director's office.

Upon issuance of a statutory notice, it is necessary within the 90 days to prepare and file a petition in the Tax Court to prevent the assessment and actual collection of tax. After the petition has been filed, the taxpayer has an opportunity to discuss a settlement with the Appellate Division in an informal conference before the case is actually docketed or a formal trial held. The nature of this conference is similar to that which follows the filing of a protest after a "30-day letter."

Whether or not these advantages are sufficient to pass the "30-day" conference may depend upon the circumstances and it always a question of individual judgment. Certainly in the great majority of cases the interests of your client are best served by an honest attempt to resolve his difficulties at the earliest time and to take advantage of every administrative opportunity available for solution.

In your evaluation of the issues and the probable conclusions, you may well determine that some additional tax is due. To stop the running of interest, your client may be willing or anxious to make a deposit representing a partial payment of the additional tax proposed in the 30-day letter. This can be accomplished in either of two ways:

1. A partial waiver on Form 870 can be executed, agreeing to certain of the proposed adjustments. A payment can be tendered with this agreement or an assessment of the additional tax admitted is made in the regular assessment procedure.
2. A flat deposit can be made with the District Director's office, with instructions for application against the tax liability for the year involved.

[1] Sec. 6212.

The execution of a partial agreement, however, may not be feasible, where relatively few or extremely controversial issues are present. When a partial agreement appears to be indicated, it should be handled with extreme care to be satisfied that concessions to be made are not against the taxpayer's interest. The volumes of tax litigation give ample evidence that the determination of the correct tax is no exact science. Short of a complete settlement of the liability, any disputed item may have potential value in the give and take often necessary to arrive at practical determination of the liability. It has happened that a conferee may be willing to concede items which, in your opinion, are weak but strongly resist concessions when you feel they should be made.

With respect to flat deposit against an anticipated additional tax, there has been some doubt as to whether the payment stops interest or not. This doubt is attributable to the Government's contention that such deposits do not earn interest and that interest payable should run until an actual assessment of tax is made. There appears to be ample authority in the 1954 Code for the District Director to make an assessment if the 30-day letter indicates a proposed deficiency and in a recent technical advice from the national office, a District Director's office was so informed. Therefore, I don't believe we should have any further interest problems with flat deposits.

Preparation of Protest

No definite format is required in the preparation; however, an instruction sheet setting forth the requirements accompanies the 30-day letter. The most significant requirements are:

a) A statement itemizing the findings of the Revenue Agent.

b) A statement of the grounds upon which the taxpayer relies.

In setting forth the grounds upon which the taxpayer relies, you are asked to put forth his case in writing. The Revenue Agent has given his side of the story in his confidential report and it is slanted to support his conclusions. It is desirable, therefore, to summarize the facts you have gathered from the taxpayer's point of view. If you have good reason to believe that your statement differs materially from that of the Revenue Agent, it should be verified with copies of evidence, if feasible, or by affidavits of persons who have first-hand knowledge of the transaction in question. Remember the burden of proof is on your client.

Your argument for the taxpayer's position is an attack on the basis of the proposal by the Revenue Agent's report; therefore, rebut it as vigorously as you can, overcoming any citations he has submitted, and give those citations which support your position.

How completely should the grounds for the taxpayer's position be covered? Should you expose your entire argument in the protest, or should some "ammunition" be withheld for an attempt to make a devastating oral argument which will demolish the last shred of the Revenue Agent's position? Here, again, the judgment of practitioners differs. My own experience would indicate that a complete argument in the protest has produced good results. Any favorable recommendation by the Appellate Conferee must be supported by him in a written report. He will usually wish to

review and study any new citation not in your protest, and he will ask you to submit in writing any new argument you may make at the conference. I believe, therefore, that an incomplete protest only serves to delay a solution.

The protest is due to be filed within 30 days after the date of the 30-day letter; however, if more time is required for a reasonable cause, an extention of time is usually granted.

The protest is reveiwed by the District Director's office which may prepare an additional memorandum in reply to the protest. The entire file is then transferred to the Appellate Division.

At this point, it should be noted that an important "rule of the game" is changed. The District Director does not have the authority to settle a tax liability on its litigative possibilities. He cannot, therefore, delegate any such powers to the Revenue Agent or informal conferee. The failure of some practitioners to recognize this restriction is at least a partial cause for some disappointment with the informal conference procedure. The Regional Commissioner has no such restriction and consequently the Appellate Division operating under his authority is permitted to consider these litigative possibilities.

Conference and Settlement

A good conference involves not merely an exercise in persuasive oratory but some intelligent planning. The conduct of the hearing should be reviewed with your client beforehand. Who should attend the conference? Should the client or a corporate officer most knowledgeable be invited and what is expected of each participant? Often there is a reluctance on the part of the taxpayer to appear at the hearing due to a lack of knowledge of some of the technical niceties—consequently, he has a fear of making inadvertent statements which could be detrimental. In some few instances, it may actually be unwise to invite a particular taxpayer to appear. Usually with proper instruction these dangers can be minimized and clients with first-hand knowledge of the background of the matter in dispute can make an important contribution, especially so at the initial conference. The first conference is primarily exploratory in nature and represents your opportunity to be sure that the Technical Adviser understands the grounds upon which you rely.

A final review is indicated just before the conference of not only the protest but your entire file and the technical basis of your position to anticipate, if possible, questions which may be raised by the Government conferee. If there is a better basis for the Revenue Agent's proposal than the one given to you or in his report, the chances are good that the Appellate Conferee will be aware of it. Now is the time to be prepared to rebut any alternative arguments.

There should be a mutual understanding between yourself and your client of a settlement that will be satisfactory, and at what point negotiations at 30-day conference should terminate in anticipation of asking for relief in a Tax Court petition. What concessions can be made, if any? As in your negotiations with the Revenue Agent, or in the informal conference, any concessions must be viewed not only as an admission of additional current tax due but with an eye to its effect on future years.

The initial conference will be held

with an Appellate Staff Technical Adviser who acts as the Government Conferee. In an unusual situation, later conferences may include other members of the Appellate Staff, a representative of the Regional Counsel's office, or even the original Revenue Agent. The Technical Adviser has a duty to recommend a basis of settlement. His recommendations are with few exceptions adopted by the Appellate Division. In making his recommendation, he is cognizant of the relative strength and weaknesses of both the Government and the taxpayer's arguments. Unlike the directions under which Revenue Agents are charged to examine returns, he is permitted to recognize the gray area between the black and white of absolute correctness and error.

If the element of compromise is necessary to arrive at a satisfactory solution, it is customary to require your client to not only agree to the amount of additional tax but to agree that no future claims for refund will be filed for the year or years in question. The same agreement Form 870 also contains a promise that the Government will not reopen the case. You can appreciate, therefore, the importance of pressing any valid claims which may be present for the years in dispute before any basis of agreement is offered to the Technical Adviser.

In an unusual case, such as the likelihood of subsequent year operating loss carry-backs, this agreement can be modified to protect the taxpayer's right to obtain the benefit of the carry-back deduction. This sounds almost like the closing agreement provided for in the Code; actually, it is not a closing agreement but the next thing to it.

If no complete agreement can be reached at this stage, the Regional Commissioner's office will issue a statutory notice in the form of a "90-day letter." Your client then must choose between a Tax Court petition or payment of the tax. If he pays the tax, he may still get relief by filing a claim for refund and in due time sue in the District Court or Court of Claims.

Conclusion

In conclusion, the handling of a tax dispute before the Appellate Division involves serious responsibilities as well as an outstanding opportunity for service. Our competence as CPAs well qualify us as fact finders with skills to evaluate evidence necessary for the determination of a tax liability in administrative hearings. Further, the actual conduct requires the standards of competence, planning, and intensive application to the same degree necessary in a difficult audit engagement. However, the rewards of an excellent performance are well worth the effort expended in client appreciation and self-satisfaction.

MINIMUM STANDARDS FOR MUNCIPAL AUDITS

By E. Waldo Mauritz

An Increasing Importance

Anyone who has been keenly interested in the business affairs of municipal government must be pleased to observe the increasing attention being given to governmental fiscal administration, including systems of internal control, reporting, and auditing standards. Obviously, this is of particular interest to accountants engaged in public practice who have maintained both professional and civic interests in municipal government. Unfortunately, too many of us do not give sufficient time and attention to the affairs of our local governments. Yet there are many reasons why we should. Consider for a moment only the magnitude of expenditures and indebtedness.

Expenditures of state and local governments in the year 1957 were 52 billion dollars. At the end of 1958 fiscal years the indebtedness of state and local governments totaled 58 billion dollars, or $335.00 per capita. Unquestionably, this is big business. Every citizen should have a keen interest in the affairs of his local governmental units, which usually are the municipality and the school; in addition, he should give close attention to the state government. Moreover, this interest should be something other than complaining about the high cost of government.

Although it appears unlikely, except for special and isolated instances, that all residents of a political subdivision will display continuing interest in the conduct of business and other affairs of local government, we have ample evidence that more and more intelligent efforts are being directed to the improvement of local government affairs.

Formula for Improved Administration

The most necessary part of a formula for improved administration in local government is sincere and active interest on the part of the corporate authorities, officials, and employees, combined with an intelligent, active electorate. When such interests combine, the foundation for improved government is well built. The tools for completing the building are also available.

With respect to fiscal affairs, many of the valuable tools can be obtained

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from the Municipal Finance Officers Association of the United States and Canada. The publications and meetings of this organization have contributed greatly to improved administration, fiscal practices, and procedures. In addition, there are the efforts of local municipal leagues, civic groups, professional organizations such as certified public accountants in their state societies and committees thereof, teachers, educators, and the courses offered in colleges and universities in public administration. The AICPA has long had a committee on local governmental accounting. Many of you are aware of the book entitled "Municipal Accounting and Auditing" which was prepared by the National Committee on Governmental Accounting. This committee came into being in the 30's and is composed of representatives of educators, practicing CPAs, municipal officials, the National Municipal League, the Municipal Finance Officers Association, the National Association of Cost Accountants, and other similar groups.

National Publications

The work of the National Committee resulted in the publication of a series of pamphlets pertaining to accounting fund structure, financial statements, governmental principles and auditing standards for municipalities. In 1951 revisions were made in some of these publications and they were condensed in the book entitled "Municipal Accounting and Auditing." This volume discusses the principles and procedures of accounting, budgeting, auditing and reporting for municipalities. With respect to municipal audit procedures, this book contains sections dealing with the following:

A. Suggested basis of understanding between the municipality and the auditor.
B. The audit procedures.
C. The audit report.
D. Suggested procedures for a complete general municipal audit.

In the section dealing with auditing procedures, it should be noted that most of the attention is given to steps to be taken in the conduct of post audits of a municipality. While some reference is made to auditing standards, it should be borne in mind that this subject was just beginning to receive a great deal of attention by the American Institute of Certified Public Accountants in its Auditing Procedures Committee. It is anticipated that a revision of the National Committee's publication will be undertaken, probably next year. When this revision is undertaken, much more attention should be given in the publication to the matter of auditing standards, which should be stated in conformity with those of the American Institute of CPAs adopted in 1954; which brings us to the relationship of the standards as enunciated by the American Institute and their effect on municipal auditing standards.

It seems appropriate, at this point, to pose this question: are minimum standards for audits of municipalities different in any material respect from the generally accepted auditing standards as determined by the American Institute of Certified Public Accountants? A related question is, if there is a difference in standards, wherein do they differ?

Auditing Standards

In order to answer these questions properly, we need to carefully examine the auditing standards as enunciated by the Institute in 1954

You will recall three groups of standards were set forth in the Institute pamphlet. The first of these were the general standards, which included the following:

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

The second group of standards pertain to field work, and such standards were stated to be:

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

The third and last group of standards pertain to standards of report. Such standards were stated as follows:

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he has taken.

Special Circumstances

Now to revert to the first and second questions. Are there certain circumstances or conditions with respect to audits of municipalities which require standards not included in the standards which have just been described? Recognizing that others might have differing opinions, it appears to your speaker that the answer to this question is "no." Some persons may advance as arguments that the minimum standards for municipalities should include adequate knowledge of and familiarity with state laws and local laws and ordinances, the intricacies of fund accounting, appropriation ordinances and the use thereof, a knowledge of the requirements contained in bond covenants and trust indentures. Others might contend that the reporting standards for municipalities are of such a specialized nature that they need special treatment in the development of minimum standards for audits of municipalities. Illustrative of such matters might be the requirement for filing reports with several officials in addition to the reports delivered to the client, that recommendations for revisions in systems and procedures need be made a part of the audit report, or that certain statements be prepared in accordance with laws or official regulations. A careful reading of the generally accepted auditing standards as published by the American Institute should lead any reason-

able person to the conclusion that these arguments are fully answered in the standards as adopted. If the independent accountant is to meet the conditions set forth under general standards; that is, that the examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor, it seems to your speaker that that accountant must then equip himself by study of the pertinent laws, municipal accounting practices, including the proper treatment of appropriations, tax levies, etc., to comply with this standard. With respect to covenants in bond ordinances and trust indentures, it seems here that there is nothing different than what one would encounter in the audit of an enterprise organized for profit which had somewhat similar problems. With respect to special report requirements, this would be merely a special detail with respect to the overall standards of reporting, and again is a matter that the independent accountant should know about or become familiar with before undertaking the engagement.

It is recognized that state and local laws in ordinances enacted by a municipality have an important bearing on the fiscal transactions of a municipality. Further, it is recognized that certain mandatory conditions with respect to records, internal control, etc., may be encountered in various jurisdictions. These requirements may result from authority given to one or more state officials and have an important bearing on the audit. All of these matters are of great importance and the independent accountant must either know what these are or make himself acquainted with these conditions, either before undertaking the audit or during the course of the audit.

It seems appropriate, at this point, to consider another argument that might be advanced with respect to standards of proficiency with respect to audits of municipalities. In certain of our states it is necessary for CPAs, and in some instances accountants licensed to practice who are not CPAs, to take a special examination designed to test the ability of the applicant in governmental accounting and auditing matters. Because such examinations are required, it appears reasonable to ask the question: does the fact that certain states have imposed such restrictions indicate that standards of proficiency for audits of municipalities should include special studies in governmental accounting and auditing and a successful completion of an examination designed to test the accountant's ability in this field? Where such conditions have been imposed in various states, the reason advanced for the establishment of such requirements has been that the audit reports prepared by practicing accountants and the accounting services rendered indicated that the need for special training and proof of ability in this specialized auditing and accounting field was necessary in the public interest. Because, for many years, little attention was given to the matter of municipal auditing and accounting in a general way by practicing accountants, it is a fact that many practicing accountants did know very little about this specialized field. Then, as it became necessary either through laws or as a result of public demand, for the accounts of municipalities to be audited by practicing accountants; that is, independent CPAs and PAs, a rather large

ield of practice opened up without dequate preparation on the part of he accountants and the municipali- ies. And it is worth noting that this ituation was not helped by the fact hat in many jurisdictions munici- palities sought, and still continue to seek, to engage accountants on a ompetitive bidding basis, as if they were buying coal, tires, or lumber. Unfortunately, it is necessary, in order o fairly tell the story, to add that ome accountants were willing to par- icipate in this plan or method of electing accountants.

Establishing Standards

The purpose of this paper is not o explore the merits of establishing pecial conditions for public practice y accountants, particularly the ex- minations for practicing accountants ualifying them for the conduct of udits of municipalities and other ocal governmental subdivisions. The irst standard commented upon be- ore, which requires that the examina- ion be performed by a person or ersons having adequate technical raining and proficiency as an auditor, learly establishes that the CPA hould know or learn enough about he type of audit to be made before ndertaking it to comply with this tandard. If a state or political sub- ivision thereof has imposed by law dditional requirements, it seems that his is merely a way in which the ocal authorities may provide added ssurance that the accountants making he audits meet the standard referred o. But if such steps or precautions re essential, then it would appear hat we should have similar laws or egulations covering all other spe- ialized fields of practice in public ac- ounting. It is doubtful if few of us would agree that a CPA should pass other special examinations before being permited to undertake audits of banks, savings and loan associations, or other specialized types of business enterprises.

Another method for the establish- ment of appropriate standards per- taining to governmental audits, and in the opinion of your speaker a pref- erable one, has been established in Illinois. Audits of municipalities are required by state law for all except the smallest towns and villages. The law is administered by the elected auditor of public accounts. The mu- nicipal audit law also establishes a municipal audit advisory board which is composed of three practicing ac- countants, three public officials, and three members at large, all appointed by the auditor of public accounts. The municipal audit advisory board has established certain standards ap- plicable to audits and reports but is giving much more of its attention to audit procedures and has issued sev- eral bulletins thereon. These pro- cedures have been put in pamphlet form and issued from time to time dealing with specific or general prob- lems and represent, to a great degree, a repetition of procedures outlined in publications of the Municipal Fi- nance Officers Association, supple- mented by the experience of the members of the board, in order to take into account special conditions neces- sary under Illinois laws.

The Illinois Law

In 1957 the General Assembly of Illinois enacted a law creating the Department of Audits, headed by an auditor general. The law requires that the auditor general be a CPA and further qualify by adequate ex-

perience to the end that the person selected shall have had administrative experience. The auditor general has the responsibility of causing audits to be made of all state agencies, that is, departments of the state government, boards, commissions, and authorities. When the auditor general undertook the examination of accounts in 1958 he requested assistance from the Illinois Society of Certified Public Accountants and also obtained the advice and assistance of accountants from ten different firms to help plan the audit programs and to determine what the audits should comprehend. After the conclusion of all of the field work, when the reports were ready for editing and summarization, these accountants were given the task of reviewing reports, with care taken to see that no one reviewed audits prepared by the firm in which he was either a partner or employee. Thereafter, when the auditor general's first report was issued, he called upon the same accountants to suggest improvements for the following year's programs. Their recommendations were accepted by the auditor general and resulted in the preparation of "Instructions of Independent Certified Public Accountants Performing Audits of State Agencies." These instructions were sent by the auditor general to each firm (approximately 54) that was selected to make audits of state agencies, boards, commissions, etc., during the year 1959. It is interesting to note that these general instructions, which are set forth in two sections, start with general instructions in Section I and deal first with auditing standards. The auditing standards specified therein are the generally accepted auditing standards published by the American Institute of Certified Public Accountants in 1954. The other topics included in Section I are:

A. Statutes and regulations.

The accountant is advised of the statutes which are pertinent to the audits of state agencies and also regulations issued by the Department of Finance and the Legislative Audit Commission.

B. Internal control.

The accountant is instructed to survey the internal control of the agency under audit, prepare two copies of his initial findings with respect thereto, and two copies of the audit program based thereon, which must be submitted to the auditor general in the early stages of each engagement.

C. Procedural and internal audits.

The accountant is required to determine if a procedural audit of the agency was conducted by the Department of Finance during the period under review, or if an examination by an internal auditor has been made; and if such is the case, he should review the reports on such audits and consider these matters in determining the scope of the audit program and the procedures to be applied.

D. Significant deficiencies.

If serious deficiencies or inadequacies in financial controls or procedures or violations of statutes are noted during the course of an audit, the accountant is required to bring these immediately to the attention of the auditor general.

E. Prior year audit reports.

The prior year audit reports are furnished to the accountant. Recommended changes in procedures or recommendations following reviews of such audits made by the auditor general or the Legislative Audit Commission should be followed up by the accountant to see what action, if any, has been taken.

F. Special confirmations.

This portion of the instructions deals with special confirmations required concerning transactions with other state agencies.

G. Examination of paid warrants.

These instructions deal with procedural matters and are merely to make arrangements for the use of one accounting firm; that is, the one making the examination of the records in the state auditor's office, for the examination of paid warrants, if the firm selected for the audit of another agency has no other reason for going to Springfield and the engagement undertaken is not of sufficient size to warrant a special visit to Springfield by this firm for the purpose of examining the warrants. In such instances the firm making the audit of the records of the auditor of public accounts is furnished a list of warrants to be examined by the accounting firm undertaking the audit of the particular agency, the examination is then made and the completed papers returned to the other accounting firm.

H. Requirements as to paper, copies and signatures.

In an effort to develop uniformity in the types of reports; that is, size, the number of copies, the time at which the reports shall finally be submitted, etc., instructions are set forth with respect thereto.

I. Review of report with agency.

The accountant is required to review each report with a responsible official or officials of each agency before submitting a preliminary draft of the report to the auditor general.

J. Preliminary drafts.

A preliminary draft of each report must be submitted to the auditor general as soon as possible after the field work on each agency is completed. Thereafter it may be necessary to confer with the auditor general, but if the report is acceptable as filed, then the accountant is notified and he proceeds with the preparation of the final report.

Section II of the instructions is entitled "Instructions as to Form and Content of Report." Again in an effort to achieve uniformity in the report; that is, in the order in which material is presented, instructions to accountants are furnished under the following captions:

A. Title of report.

B. Addressee of report.

C. Form of report.

Under this caption the report shall include a table of contents and such contents shall be described in the following captions:

Auditor's opinion
Principal financial statements
Suplemental schedules and statistical tables
Functions of agency
Books and records
Report comments and recommendations

D. Auditor's opinion.

Here it is required that the auditor express an unqualified opinion on the principal statements of the agency being audited or give clear-cut explanations of his qualifications or of his reasons for denying an opinion.

E. Principal financial statements.

Principal financial statements required in each report are:

1. Balance sheet for each fund or fund group administered by the agency.
2. A summary of operating statements comparing the original appropriation with actual operating results.
3. A summary of changes in fund equities during the period under review.

F. Supplemental schedules and statistical tables.

G. Functions of agency.

The accountant is required to submit a brief summary of the functions performed by the agency and the statutory authorization for the agency's existence shall be set forth in this section of the report.

H. Books and records.

Comments are to be included listing the books and records maintained and a brief description thereof. In addition, if the records are not adequate or do not comply with statutory or other requirements, conditions shall be noted and included in the report comments and recommendations made in respect thereof.

I. Report comments and recommendations.

You will note that in these instances the accountants are guided by instructions, checklists, etc., which certainly appears preferable to rather rigid statutory restrictions since the latter are rather inflexible and certainly most difficult to change as conditions make changes both necessary and desirable. There is no question but what there will be changes in the instructions to accountants in future years by the auditor general. Some of these will result from experience gained in each year and some will arise from changing conditions with respect to agency operations or state laws. With respect to municipalities, it is interesting to note that the Municipal Audit Advisory Board has just completed the preparation of a rather large manual of procedures, which is to be made available to practicing CPAs and to the public officials of the municipalities. This manual is undergoing careful review by the Municipal Audit Advisory Board and the Illinois Society of CPAs. Again, it certainly seems most likely that changes will be necessary in this manual from time to time, but the procedures are such that the flexibility which is necessary can be achieved under the present system.

An Evaluation

While in the opinion of the author, the auditing standards set forth in the American Institute's publication thereon concerning general standards and standards of field work are entirely applicable and acceptable as minimum audit standards for municipalities, some problems arise in the area of reporting standards. These problems arise principally because of questions concerning generally accepted principles of accounting. Most of you know that considerable attention has been given within the past few years to the matter of special reports; reports on not-for-profit organizations, municipalities, hospitals, educational institutions, etc. Drafts of material for a booklet on this subject have been prepared and submitted to various interested committees and persons for review, comment and criticism. It is expected that out of these efforts will come some clarification on this subject, particularly as it pertains to governmental accounting. As stated earlier, what is urgently needed is a thoroughgoing revision of the publication "Municipal Auditing and Accounting." Since the last revision of this book, municipalities have undertaken numerous activities and enterprises which are in most cases the result of changing municipal operations. Automobile and air transportation have created many additional problems for municipalities and as a result we have municipalities operating airports, off-street parking lots, parking meters, and municipally owned garages for parking of privately owned automobiles. These matters should be adequately dealt with in the revised publication. What is more important is that much more attention should be given to the matter of what we are talking about today that is, auditing standards, and further, that the principles as enunciated in the publication be revised to differentiate principles and procedures.

TAX COMMENTS

Conducted by the Committee on Taxation of the Illinois Society of Certified Public Accountants

THE ANSWER OF CONGRESS TO THE PROBLEM OF STATE TAXATION OF INCOME FROM INTERSTATE COMMERCE

One of the highlights of the first session of the 86th Congress was the enactment of P.L. 86-272 [1] relating to the state taxation of income from interstate commerce. Many did not expect enactment of federal legislation during 1959 as a result of the current *Northwestern States* and *Stockham Valves* cases.[2] However, within less than seven months from the time the decision was rendered by the Supreme Court, the President had signed a bill which may be said to nullify substantially the disturbing dictum set forth in the decision. Although some of the provisions of the new law may not completely satisfy a number of taxpayers, its enactment should be regarded as a legislative achievement.

Legislative Background

One of the reasons for the passage of P.L. 86-272 was the amount of legislative interest demonstrated by a large number of citizens. Members of Congress stated that their mail on this question was second in volume only to that received on the emotionally charged issue of labor legislation. Hearings were held by the Senate Select Committee on Small Business to gather material to study the problem of state taxation of income arising from interstate commerce raised by the cases. At the first hearing held on April 8, twenty-five persons, representing a variety of interests, made prepared statements bearing on the problem. A second hearing was held by the same committee in Boston on May 1 at which twenty-six additional witnesses submitted statements. More mail was received on the subject of the *Northwestern States* and *Stockham Valves* cases than on any other matter since the inception of the congressional committee submitted its report recommending (1) establishment of standards for testing the authority of states to tax outside business and (2) the establishment of a commission to study all phases of the problem of the state taxation of interstate commerce.

The Senate Finance Committee held hearings on July 21 and July 22 on S. 2213, S. 2281, and S.J. Res. 113, all of which related directly to the problem. Forty-six statements were submitted presenting both sides of the question and eighty-one telegrams and letters were included in the committee

[1] 15 U. S. C. A. 381.

[2] *Northwestern States Portland Cement Co. v. Minnesota and Williams v. Stockham Valves and Fittings, Inc.* 350 U. S. 534, 79 S. Ct. 383 (February 24, 1959).

CHARLES L. SCHUBER, a member of the Illinois Society's Committee on Taxation, prepared the tax comments for this issue. He is employed by the Natural Gas Pipeline of America, Chicago, Illinois.

report. The testimony disclosed grave concern by both the large and small taxpayer shipping goods to other states for, under the existing decisions, income tax liability could result in a foreign state by delivery alone. The Senate Finance Committee submitted its report with draft legislation on August 11.

Two Proposals

As a result of the wide publicity given the matter, eleven bills were introduced in Congress during June, July, and August. Two different approaches were presented in the two bills. The bill reported by the House Judiciary Committee, and originally approved by the House, provided that taxation of the income of a business engaged in interstate commerce was forbidden unless the business also engaged in certain activities, including maintenance of an office, salable inventory, a warehouse, or other place of business in the taxing state. Activities also included the maintenance of an officer, agent, or representative in the state. In substance it provided that income of interstate commerce was free from state taxation under certain conditions. The rendition of services alone would not result in subjecting a concern to income tax. The House bill was essentially a stop-gap measure and provided for Congressional Committees to study the problem in hope of a fair and permanent solution.

The Senate bill approached the problem in a different manner. It provided that no state would have the power to impose a tax on business net income derived from the sale of tangible personal property in interstate commerce if the only business activity was either or both (1) the solicitation of orders accepted to be filled from without the state or (2) the solicitation of orders for the benefit of a customer of the solicitor and the orders are accepted and filled from without the state. The Senate bill contained a more specific treatment of dealings through an independent contractor by providing that an out-of-state business would not be considered to be conducting business activities within the state by reason of solicitation of orders or sales in that state by an independent contractor on its behalf.

The Senate passed this bill on August 20. The House, upon receiving the Senate bill, eliminated all but the enacting clause and substituted the revised bill of the House Judiciary Committee. The bill then went to conference and the Conference Committee reported on September 1.

The conference report indicated that a clarifying amendment to the Senate bill was inserted to make certain that the maintenance of an office by an independent contractor within the State would not subject out-of-state business to income taxation. The House conferees considered it more appropriate to accept the language relating to the minimum activities approach as it appeared in Title I of the Senate bill. The conference report also stated that due to the complexity of the issues a study of the entire problem was desirable with a view toward the enactment of appropriate legislation by the Congress. The Senate bill provided for such a study by an independent commission whereas the House bill provided that the study was to be made by Congress itself. The latter provision was incorporated into the final draft which was signed into law by the President on September 14, 1959.

A number of reasons may explain he swift passage of P.L. 86-272. The road language of the court in the *Northwestern States* and *Stockham Valves* decision, when considered by he small business man, affected a arge number of taxpayers. It put oubt in the minds of many about tate income tax liability arising from he smallest activity in a foreign state. For the first a substantial burden of ompliance was placed upon many axpayers. The small business man requently did not have available the ccounting data necessary to comply vith foreign state income tax laws, nor id he have an understanding of the aried laws involved. The government enefited from passage of the law be- ause frequently the cost of compli- nce by small taxpayers substantially xceeds the state tax liability. In uch cases the federal government uffers a net revenue loss.

Provisions of the New Law

P.L. 86-272 is composed of Title I, stablishing the minimum standard or state taxation of interstate com- nerce, and Title II, providing for a tudy and report by the Committee of he Judiciary of the House and the Finance Committee of the Senate be- ore July 1, 1961.

Section 101(a), the first section nder Title I, provides that no state hall have the power to impose a net ncome tax on income derived within state by a person from interstate ommerce if the only business activi- ies within such state are (1) solici- ation of orders of tangible personal roperty which are sent outside of he state for approval and are shipped rom a point outside and (2) solicita- ion is in the name of or for the benefit f a prospective customer if orders by the customer enable the solicitor to fill orders described in (1) Section 101(b) establishes the rule that the limitation of the power to tax does not extend to corporations incorporated under the laws of a particular state or to any individual who is domiciled in or a resident thereof. Section 101(c) states for the purpose of subsection (a) that a person shall not be considered as having engaged in business activities within a state merely by reason of sales, or the solicitation of orders of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance of an office by one or more independent contractors whose activities on behalf of such person consist solely of making sales or soliciting orders for the sale of tangible personal property. Section 101(d) defines an independent contractor and provides the term "representative" is not an independent contractor.

Section 102 states the effective date of the law and provides a limitation of the power of the states to assess tax prohibited by Section 101 for taxable years ending before the date of approval of the bill. Section 103 defines "net income tax" and Section 104 contains the usual savings clause which provides that if one section of the law fails, others will not automatically fail.

An Interpretation

In essence, for the first time in our history, a federal law establishes a limit for states to tax income derived from interstate commerce. P.L. 86-272 establishes the rule that if the only business activity carried on in a state is solicitation, such state may not impose an income tax on the income de-

rived therefrom. The word in the law that seems most likely to attract judicial attention is "solicitation." Does this word have reference only to the activities of the itinerant drummer, or can it be extended substantially beyond his activity? If one turn to the legislative intent, a definite answer is not found. It can be argued the Talmadge Amendment would preclude the use of an office. The following language, appearing after Section 101(a)(2) was removed by that amendment:

> (3) the maintenance and operation by such person, or by his representative, in such state of an office the primary purpose and use of which is to serve representatives of such person who are engaged in the solicitation of orders described in paragraph (1) or (2), or both, and to receive, process and forward such orders.

It is submitted the above language does not cover an office used solely for solicitation. The large taxpayer can become the subject of discrimination if its income is taxed because of the use of an office to supervise efficiently a large sales force. This is so because the small taxpayer can function with a single salesman without an office and not be subject to tax.

Some have asked the question whether the so-called rule of exclusion when applied to the new law will permit the states to enlarge the field within which their income taxes may be imposed. This would follow on the theory that, Congress having specified activities which cannot be taxed, has given implicit consent to their taxation of all other activities. The answer to this question is found in the Senate Report which states the bill does not give the states any power to tax income derived from interstate commerce and the power of the states in this respect will be determined with no inference from the bill.

Conclusions

What is certain is that Congress has accepted the minimum activities approach in limiting the states' power to tax income derived from interstate commerce. It has specifically overruled by legislation the Louisiana cases of *Brown-Forman Distillers*[3] and *International Shoe Co.*[4] wherein tax liability existed in a fact situation which included only salesmen in the state without other business activity of any kind.

The wide general interest shown in the problem of such taxation of interstate commerce and the legislative dispatch exhibited by Congress should certainly be characterized as noteworthy. It is hoped comparable interest will be displayed in connection with the general study of the problem scheduled for consideration in the months ahead.

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[3] *Brown-Forman Distillers Corp. v. Collector of Revenue*, 101 So. 2d 70 Certiorari denied by U. S. Supreme Court 79 S. Ct. 602 (March 2, 1959).

[4] *International Shoe Co. v. Fontenot*, 359 U. S. 984, 79 S. Ct. 943 (May 4, 1959).

REPORTS ON EXAMINATION OF PERSONAL ACCOUNTS

By W. R. Cusimano

Today's independent certified public accountants are accustomed to the demands of a modern economy for a wide variety of services. These services range from audits of small manufacturing companies to the broad implications of formulating the plans and implementing the installation of electronic data-processing equipment for large corporations. The accountant may be engaged in preparing the simplest type of personal income tax return any given day and on the next day be engaged in the intricate problems of tax planning.

In the majority of his audit engagements the auditor has clearly marked standards for the performance of his work. His education, training, and experience have equipped him to perform the requisite field work and to render a report in accordance with the highest professional standards. When specialized audit services are required, his background of accounting training and his familiarity with the "audit trail" provide an excellent foundation for the successful conclusion of the field work. Then comes the time to report. Here the guideposts are not so clearly marked and the CPA finds he must render a "special purpose" report, one in which the financial statements may not conform to "generally accepted accounting principles."

Problems in Reporting

Special-purpose audit reports have caused a great deal of concern to the independent certified public accountant because the variety of such reports is virtually limitless. It is generally recognized that the standard short-form report is intended primarily for reporting on examinations of business enterprises organized for profit and frequently is not appropriate for use in special-purpose reports. Strides to bridge this important gap were made by the Committee on Auditing Procedures of American Institute of Certified Public Accountants when it issued, in 1957, Statement No. 28. The purposes of the statement were:

a) To provide a basis for differentiating between reports for which the wording of the usual short-form opinion or certificate (whether used in a short-form or long-form report) is appropriate and reports for which special wording in the opinion or certificate seems to be necessary.

b) To clarify the applicability of generally accepted auditing standards to such special reports.

Much of the literature, discussions, and studies on special-purpose reports

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has been directed toward non-profit organizations such as hospitals, educational institutions, and municipalities, because this type of organization has increased greatly in both size and importance in recent years and because its accounting problems differ significantly from those of corporations organized for profit.

Useful Records and Reports

On the other hand, less attention has been directed by the accounting profession toward reports on examination of personal accounts of individuals. This type of service usually arises for individuals or families of considerable wealth and with diversified financial interests. These individuals often employ an agent to care for and to administer their holdings. An examination by a certified public accountant is often made at the request of the principal or the agent himself in order to afford evidence of proper fiduciary responsibility.

The records in such cases are usually well-maintained and internal control, both physical and book, may be satisfactory. The assets may include securities, real estate investments, producing oil wells, mining properties, miscellaneous receivables, and cash. Incoming cash receipts are usually by check, and disbursements are normally adequately supported. Therefore, normal audit procedures can be used. Liabilities are usually minor in amount except for income and other taxes. However, from this point of initial similarities various characteristics peculiar to this type of examination appear which distinguish it from the more frequently encountered types of audits.

An important distinguishing feature between the individual and the non-profit organizations for which many special-purpose reports are intended is the income tax consideration. Non-profit organizations usually have no income tax problems because of their tax-exempt status, whereas individuals who require specialized audit services usually have considerable income and the income tax problems are of great concern to them. Because of the impelling tax considerations the accounting records and procedures will usually be maintained on a basis acceptable for income tax purposes. Depending upon the extent and diversity of his financial interest, an individual's records may be maintained on a pure cash basis, modified cash basis, or a hybrid basis. Because of this, considerable resourcefulness is required of the auditor to describe adequately the scope of his examination.

Scope of the Examination

A good starting point would be to determine the purpose of the examination. As stated before, one purpose of the examination may be to satisfy the principal and agent as to the latter's proper discharge of the latter's fiduciary responsibility. Financial statements that show inventories of the assets and changes therein as administered under the agent's control, related income that should have been received, and authorized disbursements, will accomplish this purpose.

The question of what financial statements are likely to be most useful to the individual should also be considered. Among the items the statements may furnish are the following:

1. Income tax basis of assets.
2. Market value of assets.
3. Income tax liability.

4. Other liabilities.
5. Taxable and non-taxable income.
6. Deductible and non-deductible expenses for tax purposes.
7. Sources of income—capital gains, dividends, etc.
8. Lists of personal expenses.

In order to present for the guidance f the individual any or all of these nformative items, together with the nancial statements best suited for ne use of the agent, discernment and idgment on the part of the accountnt must be exercised. To prepare nancial statements based upon item or 2 above, for example, would not ecessarily "present fairly the fiancial position" at a given date. To eport income based upon item 5 r 6 would not necessarily "present airly the results of operations for the eriod."

ccounting Methods

Although the *income tax basis* may ot be a generally accepted way of tating assets in financial statements, does provide a useful and practical asis. In deciding whether or not cerain assets should be sold or held, one ust know the tax basis of such assets nd having this information on fiancial statements can be extremely seful to the client.

Assets carried on the income tax asis may be at cost as to those acuired by purchase, at values estabshed for Federal estate tax purposes s to those acquired by bequest, or at onor's basis as to those acquired by ift.

Stating assets at *current or market alue* might have great advantages if were practicable. However, it may e too difficult and costly to obtain urrent values for such assets as real state, interests in mineral deposits, and certain types of personal property, to be feasible. It is generally both practical and desirable to show in the statements the quoted market value of marketable securities. This can be done by reflecting the securities at the tax basis with the quoted market value shown parenthetically.

An individual's income may be derived from interest and dividends on securities owned, distributions from trusts, royalties from mineral interests, and income from sundry business ventures. His expenses may be attributed to the management of his business affairs, may be personal in nature, or may be a combination of both. The statement of income and expenses would be more meaningful if the statement were presented to show under separate captions taxable and nontaxable income, and expenses relating to income-producing properties and personal expenses.

It is generally practical, however, to make an examination of accounts relating to business investments of the individual, which are maintained at a certain location or by an agent. Because of the income tax implications, such records are usually maintained in good order, making an audit feasible.

Accountant's Opinion

Examination of cash transactions only when confined to certain well-defined funds or bank accounts should not present any serious problems in defining the scope of the examination and in expressing an opinion as to the fairness of such statement. An example of a report that may be appropriate follows:

> We have examined your statement of cash receipts and disbursements for the year ended December 31, 19.... which is based on cash transactions recorded in

your general accounting records maintained by your agent, Blank Corporation. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying statement presents fairly such of your cash receipts and disbursements for the year ended December 31, 19.... as are recorded in your general accounting records maintained by your agent, Blank Corporation.

Examinations limited to assets and liabilities arising from cash transactions maintained at a certain location or by an agent, although a little more involved than an examination of cash transactions only, again should present no serious problem. It is important, however, that the accountant clearly define the scope of his examination. He should disclose significant omissions of assets or liabilities or other matters that may have an important bearing on the financial statements, even though they do not come under the scope of the examination.

As mentioned previously the accounting records are usually maintained on a basis acceptable for tax purposes. The auditor may find any of the following situations:

1. Accounts maintained on cash receipts and disbursements basis.
2. Accounts maintained on a modified cash basis.
3. Accounts maintained on an accrual basis.

On whichever basis the accounts are maintained, the auditor may be asked:

a) To include all expenditures, personal and otherwise.

b) To limit his examination to records maintained at a certain location or by an agent of the individual.

The feasibility of making an examination of financial statements on which an opinion can be expressed will depend on the adequacy of the records to be examined. It would be extremely difficult, if not impossible, to make an examination of all assets and liabilities and related transactions of an individual because of general lack of adequate records, especially as relating to expenditures of a personal nature, such as individual residence household furnishings, art objects and jewelry, recreation, etc. Also, most of these non-business assets were purchased to fit the needs and personal taste of the individual and in all probability would not fit the needs of others; therefore, resale (or market) value would be substantially less than original cost. Liabilities relating to personal expenditures would be difficult to determine. Under such circumstances, it seldom is practical to make an examination in which an opinion can be expressed under the stipulations imposed by item (a) described above.

An example of a report that may be appropriate where no qualifications are necessary follows:

We have examined your statement of assets and liabilities as of December 31, 19.... and the related statement of revenue, expenses, and capital account for the year then ended, which are based on cash transactions recorded in your general accounting records maintained by your agent, Blank Corporation. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records mentioned above and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying statements present fairly such of your assets and liabilities at December 31, 19.... and revenues, expenses, and changes in capital account for the year then ended as arose directly from cash transactions recorded in your general accounting records maintained by your agent Blank Corporation

on a basis consistent with that of the preceding year.

An examination of records maintained on a modified cash basis or other hybrid basis is generally more difficult. The basis of accounting should be described in more specific terms than in reports where records are maintained on an accrual or "pure cash basis."

Hybrid bases of accounting generally arise from the desire of individuals to maintain the records on a tax basis. Assets may be carried at cost or other tax basis. Liabilities may be recorded only as they relate to borrowings for acquiring income-producing assets or for accruals allowable for tax purposes. Provisionary charges for depreciation, depletion, and amortization are generally made only on income-producing assets and in amounts allowable for income tax. Income may be reported on the cash or instalment basis. Therefore, the assets may be carried at values that do not purport to represent current or realizable values.

An example of a report that may be appropriate follows:

> We have examined your statement of assets and liabilities as of December 31, 19.... and the related statement of income, expenses, and capital account for the year then ended, which are based on transactions recorded in your general accounting records maintained by your agent, Blank Corporation. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records as we considered necessary in the circumstances.
>
> The accounts are maintained on the cash receipts and disbursement basis except for provisionary charges for depreciation, depletion, and amortization of income-producing assets and for income taxes. Securities owned are carried at values that do not purport to represent current or realizable values (see Notes ..... to Exhibit A for basis of valuation).
>
> In our opinion, the accompanying statements present fairly such of your assets and liabilities at December 31, 19— and income, expenses, and changes in capital account for the year then ended as arose from transactions recorded in your general accounting records maintained by your agent, Blank Corporation, on the basis indicated in the preceding paragraph, which basis is consistent with that of the preceding year.

In comparing the wording of the examples of reports given in this paper with the standard short-form report, you will note the examples omit any reference concerning conformance of the financial statements with "generally accepted accounting principles" and omit any statement that they "present fairly the financial position and results of operations."

Financial statements that do not include all the assets and liabilities and related income and expenses do not purport to present financial position and results of operations. The three examples of reports given herein are based on examination of only a portion of the assets and liabilities of an individual; therefore, the financial statements do not present fairly the financial position or results of operations.

Accounting Principles

The financial position indicated in an audit report implies conformance with "generally accepted accounting principles." What is meant by accounting principles? The committee on terminology of the American Institute of Certified Public Accountants has defined "principle" as used in accounting as follows:

> Initially, accounting postulates are derived from experience and reason; after postulates so derived have proven useful,

they become accepted as principles of accounting. When this acceptance is sufficiently wide-spread, they become a part of the "generally accepted accounting principles."

Most of the generally accepted accounting principles have been directed toward the accounting of business enterprises organized for profit. In recent years generally accepted accounting principles have been clearly defined for some nonprofit organizations such as municipalities and educational institutions that follow accounting practices differing in some respects from those followed by businesses organized for profit.

To compare the individual to the non-profit organization in this discussion was not the intended objective. In more respects than not the goal of the individual is like the "profit-type" business—to make a profit and increase earnings or spendable income. Within a relatively few years it may become an accepted practice for an individual to keep his records on the modified basis—providing for depreciation, etc., on his income-producing assets, providing for his potential of as yet unsustained losses, etc., and in effect maintaining his records as if they pertained to a business proprietorship. When such postulates have proven useful and appeal to reason a form of opinion reflecting the "generally accepted practice" may evolve.

The accounting profession should direct additional attention toward development of accounting principles for personal accounts of individuals so that more uniformity can be obtained in presenting financial statements of individuals.

ACCOUNTING REPORTS

Accounting statements tell of the accountability of corporate management for property placed under their control by third parties; of their responsibility for the proper use of money borrowed under a liability; for the cost incurred and the dividends declared. Accounting information also affords a basis for determining governmental revenue—property taxes, excise taxes, income taxes. Clearly accounting is an important means of communication in modern industrial society. To serve this purpose well, accounting information must be skillfully compressed out of a mass of facts; it must be dependably factual, informative and reliable. To this end auditing (internal and external) puts transactions and classification under critical scrutiny for authenticity and relevance. Authenticity establishes the reliability of account as affected by the nature of the transaction. Relevancy establishes the account as trustworthily informative because the originating transactions are known to refer to this enterprise, to belong in the accounts where they are entered and to apply to the fiscal periods as reported in the accounting statements.

A. C. Littleton, *Structure of Accounting Theory*

IDEAS FOR THE LOCAL PRACTITIONER

Conducted by the Committee on Local Practitioners of The Illinois Society of Certified Public Accountants

A SIMPLIFIED SYSTEM OF INDEXING WORKING PAPERS

Most local practitioners are so occupied with their daily work that they ave little opportunity to do office procedure planning for their own office. Recognizing this condition to exist, the Local Practitioners Committee has sked their colleagues to share certain tested office procedures with the entire ociety membership. The following paragraphs describe one such procedure.[1]

A good simplified uniform index method for working papers can be an xcellent time saver in that one can frequently locate the schedule desired uickly without first referring to the index sheet of the work papers.

Here is a very simple system in which the initial of the major classifica- ions, in general, suggests the index letter:

A—Agreements, minutes, etc.
C—Current Assets
D—Deferred charges and prepaid expenses
F—Fixed assets
G—General (Other) assets
L—Liabilities
LT—Long term liabilities
N—Net worth
R—Revenue
X—Expenses
Z—Miscellaneous

For permanent file classifications the letter P is placed before the index etter. Thus PD would indicate a deferred charge schedule found in the ermanent file.

Sub indexing is accomplished by placing a number after the major classi- ication letter. Thus a sub-breakdown for current assets might take somewhat he following form:

C 1 to C 9	Cash
C 10 to C 19	Accounts Receivable
C 20 to C 29	Notes Receivable
C 30 to C 39	Inventories

[1] This procedure was suggested by Robert Heinsimer & Co., Chicago, Illinois.

Robert Heinsimer, Leo L. Kaner, and Russell G. Patchak, all practitioners in Chicago, Illinois, prepared the comments for this issue. All are currently members of the Illinois Society's Local Practitioners Committee.

While prepaid expenses are generally classified as current assets, it suggested that for the purposes of indexing only, that prepaid expenses given index numbers D 1 to D 20.

For permanent file indexing a similar use of letters and numbers may employed. For example, the net worth section of the permanent file may indexed somewhat as follows:

PN 1 to PN 9	Capital stock—common
PN 10 to PN 19	Capital stock—preferred
PN 20 to PN 29	Paid in surplus
PN 30 to PN 39	Appropriated surplus
PN 40 to PN 49	Earned Surplus

The advantages of the foregoing system are that it gives uniformity indexing the working papers, aids in locating papers frequently witho reference to the index itself, and the letters to be used are easily memorize

If the client has a good system of numbering accounts the indexing syste above mentioned for letters adapts itself very well utilizing the client numbering system to the schedules. Assume a client's numbering system f cash consists of the following accounts:

Account No.	*Name*
1	Petty Cash
2	A Bank
3	B Bank

Your schedule numbers could correspond. The schedule numbers for indexi would be:

Schedule No.	*Name*
C 1	Petty Cash
C 2	A Bank
C 3	B Bank

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